

Scienter Requirements Under Section 10(b) and Rule 10b-5

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malice test focuses on the defendant's knowledge of the truth or falsity of his statement, its use appears awkward in the context of the reportorial privilege where the reporter's knowledge of the statement's veracity is wholly immaterial.⁴³ Nevertheless, the Court might analogize this situation to *Firestone's* treatment of the *Gertz* negligence standard and the reportorial privilege by imposing liability on the basis of the reporter's knowledge that his report failed to conform, or his reckless disregard of the issue of conformity. However, such applications ignore the artificiality of the fault standards when applied to defamation actions which do not involve the issue of truth or falsity of the matter reported, and the Court should instead attempt to articulate a more realistic framework which would be compatible with all of the peculiarities of defamation law.

Paula Hazelrig Hickman

SCIENTER REQUIREMENTS UNDER SECTION 10(b) and RULE 10b-5

Respondents, defrauded when the president of a small brokerage firm induced them to invest in nonexistent escrow accounts,¹ brought an action against petitioner accounting firm for damages pursuant to Section 10(b) of the Securities Exchange Act of 1934² and rule 10b-5 of the Securities and Exchange Commission.³ Basing the cause of action on an allegation of

43. See text at note 10, *supra*.

1. The president of First Securities Co. of Chicago perpetrated the fraud from 1942 until 1966 by enforcing a "mail rule" in his office. All mail addressed to him could be opened only by him, thereby preventing discovery of the fraud by others in the company. Suit was filed against First Securities' accountants, Ernst & Ernst, because in their review of internal audit controls of the company they failed to discover the mail rule. For a more complete discussion of the financial misdealings, see *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1103-04, 1109 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975), and opinions cited therein.

2. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970) [hereinafter cited as Section 10(b)]: "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." (Emphasis added).

3. 17 C.F.R. § 240.10b-5 (1976) [hereinafter cited as rule 10b-5]: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumen-

negligent nonfeasance, respondents disclaimed any fraudulent conduct on the part of petitioner. The United States Supreme Court, reversing the Court of Appeals,⁴ held that in the absence of an allegation of intent to deceive, manipulate, or defraud, no private action for damages may lie under Section 10(b) of the Securities Exchange Act and SEC rule 10b-5. *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976).

The Securities Act of 1933⁵ and the Securities Exchange Act of 1934,⁶ largely outgrowths of the depression, were enacted by congressmen intent on providing "truth in securities."⁷ While the former Act dealt principally with abuses in the sale of newly issued securities and in the distribution of outstanding securities,⁸ Congress enacted the latter statute to regulate transactions in issued securities.⁹ The 1934 Act contained Section 10(b), a "catch-all"¹⁰ provision for the prevention of manipulative devices, which

tality 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."

4. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), cert. granted, 421 U.S. 909 (1975); *Noted in* 44 GEO. WASH. L. REV. 158 (1975), 28 VAND. L. REV. 269 (1975), and 20 VILL. L. REV. 1081 (1975).

5. Securities Act, ch. 38, 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1975).

6. Securities Exchange Act, ch. 404, 48 Stat. 881 (1934), as amended, 15 U.S.C. §§78a-hh (1975) [hereinafter cited as the 1934 Act].

7. As a result of flagrant dishonesty in the stock market, Congress found it necessary in 1933 to restore the public confidence which existed prior to the 1929 crash. Professor Cohen coined the phrase "truth in securities" to characterize the broad goal of Congress in enacting the Securities Act of 1933, though the phrase aptly describes the goal of the 1934 Act as well. Cohen, *Truth in Securities Revisited*, 79 HARV. L. REV. 1340, 1344-66 (1966). See also Comment, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 659-60 (1965).

8. I A. BROMBERG, SECURITIES LAW: FRAUD, § 2.2(100) at 21 (1970) [hereinafter cited as BROMBERG].

9. S. REP. NO. 792, 73d Cong., 2d Sess. 1 (1934).

10. HEARINGS ON H.R. 2852 AND 8720 BEFORE THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 73d Cong., 2d Sess. 115 (1934) (Statement of Thomas G. Corcoran). Mr. Corcoran's reference to Section 10(b) as a "catch-all" provision presumably was based on the generality of the language of the Section as compared to other sections of the 1934 Act and of the Securities Act of 1933. Section 10(b) applies to any person and any manipulative or deceptive device or contrivance, whereas, for example, Section 11 of the Securities Act of 1933 deals specifically with persons buying on the faith of a registration statement and Section 12(2) of the same Act imposes liability for misrepresentations or omissions within a prospectus. Also,

granted the SEC the authority to promulgate rules for its implementation.¹¹ Of the dozen rules presently in effect, rule 10b-5 has been the primary source of a proliferation of federal securities cases.¹²

In interpreting the congressional and administrative intent behind Section 10(b) and rule 10b-5,¹³ the judiciary has recognized an implied private right of action for damages,¹⁴ and as a result, has facilitated the increase in litigation. Relying on the language of Section 10(b), the courts have agreed upon three of the elements of a private action for damages: use of the mails or instrumentalities of interstate commerce, purchase or sale of a security, and employment of a deceptive or manipulative device.¹⁵ The requirement and meaning of a fourth element, scienter, has been the subject of pervasive confusion and disagreement among the federal courts¹⁶ as well

Section 18 of the 1934 Act permits recovery by persons relying on false reports filed with the SEC. *See generally* 5 A. JACOBS, THE IMPACT OF RULE 10b-5, §§ 3.01-.02, 1-25 to 1-44 (1st ed. 1974) [hereinafter cited as JACOBS].

11. Section 10(b) is not self-implementing as its language indicates. *See* note 2, *supra*. It is significant that the SEC, in effecting its rulemaking power, may not expand or otherwise alter the scope of the legislative enactment. *See Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1391 (1976). *See generally* 6 L. LOSS, SECURITIES REGULATIONS, 3883-84 (Supp. 1969) [hereinafter cited as LOSS]. Thus the court in *Hochfelder* is relatively unconcerned with the administrative history and construction of rule 10b-5, because the language of Section 10(b) provides a sufficient basis for their holding.

12. 3 BROMBERG § 12.1 at 266. *See also*, 5 JACOBS § 1 at 1-4 to 1-5; Loss, *Reporter's Introductory Memorandum*, Federal Securities Code, xvi (ALI Tent. Draft No. 2 1973).

13. For a summary of the legislative history of Section 10(b) see 1 BROMBERG § 2.2(331-340) at 22.2-.6, and for a summary of the administrative history of rule 10b-5 see 5 JACOBS § 5.02 at 1-108 to 1-113.

14. The federal judiciary first found an implied private action under the Section and the rule in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946), and the United States Supreme Court confirmed the right in *J.I. Case v. Borak*, 377 U.S. 426, 432 (1964). The Court's most recent reaffirmation of the right of action was in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). Virtually every federal circuit court has either upheld specifically or recognized in dicta the implied private right of action. *See Comment, Lanza v. Drexel & Co. and Rule 10b-5: Approaching the Scienter Controversy in Private Actions*, 15 B.C. IND AND COMM. L. REV. 526, 527 n.12 (1974).

15. *E.g.*, *Boone v. Baugh*, 308 F.2d 711, 713 (8th Cir. 1962). The United States Supreme Court recently affirmed the most controversial of the elements, the requirement of a purchase or sale of a security, which was first established in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). *See generally* 2 CCH FED. SEC. L. REP., ¶ 22,781 (1976).

16. *Compare Tomera v. Galt*, 511 F.2d 504, 508 (7th Cir. 1975) ("need not prove nor plead scienter") and *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert.*

as among commentators.¹⁷

The Supreme Court in the instant case made its initial effort at resolving this confusion. The Court reviewed the statute, its scant legislative history, and the administrative history of rule 10b-5,¹⁸ and without discussing the public policy issues, concluded that an allegation of scienter is required in a private action for damages.¹⁹ Because the Court found an

denied, 390 U.S. 951 (1968) ("Proof of 'scienter,' *i.e.*, knowledge of the falseness of the impression produced by the statements or omissions made, is not required under Section 10(b) of the Act.") with *Clegg v. Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974) ("something additional by way of scienter or conscious fault than mere negligence"), *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974) ("some culpability beyond mere negligence"), and *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) ("proof of a willful or reckless disregard for the truth") and *White v. Abrams*, 495 F.2d 724, 734-35 (9th Cir. 1974) ("proper standard to be applied is the extent of the duty that rule 10b-5 imposes on this particular defendant") and *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 407 (3d Cir. 1973) (refused to determine the amount of "recklessness" necessary for scienter). See generally 2 BROMBERG § 8.4(501) at 204.101-.102; Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 PA. L. REV. 597, 631 (1972).

17. See, e.g., Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 570 (1972) ("... scienter should be interpreted to mean knowledge of the facts, either actual or constructive"); Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 SO. CAR. L. REV. 653, 662-63 (1975) (only negligence should be required); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206, 1220 (1970) (must realize that the courts are dealing with a continuum of conduct rather than "nebulous legal categories of fraud"); Ruder and Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1125, 1141 ("Basing the dividing line regarding culpability upon the distinction between recklessness and negligence offers the trier of fact the best opportunity to achieve just results."); Comment, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1067-68 (1969) (would find culpable those who are relied upon by others and who negligently fail to disclose); Note, 32 U. CHI. L. REV. 824, 839 (1965) (argues that a negligence standard best effectuates the goals of the securities legislation).

18. See note 13, *supra*.

19. *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1391 n.33 (1976). However, the Court did not completely ignore policy issues. Later in the same footnote it is acknowledged that "[a]cceptance of respondents' view would extend to new frontiers the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress." Other relevant policy issues would include, for example, protection of the innocent investor, maximization of the dissemination of information to the public, and the equalization of access to information between the buyer and seller of securities. For a discussion of these and other such issues, see *White v. Abrams*, 495 F.2d 724, 728 (9th Cir. 1974); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 592 (5th Cir. 1974); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 287 (3d Cir. 1972) (Adams, J., concurring and dissenting); and *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971). See also Bucklo, *Scienter and*

absence of any indication of an expansive congressional intent in enacting Section 10(b), it refused to extend coverage of the Section to private actions for damages based on negligence alone.²⁰

In construing the language of Section 10(b) the Court relied upon terms within the statute which strongly suggest "that Section 10(b) was intended to proscribe knowing or intentional misconduct."²¹ Congress' use of the term "manipulative" was especially persuasive, because in 1934 it was a virtual term of art which connoted "intentional or willful conduct designed to deceive or defraud investors."²² While acknowledging the broad, remedial goals of the 1934 Act,²³ the Court refused to construe the entire Act expansively, finding instead a congressional intent to embody within each section a particularized standard of fault. Thus the majority determined that Congress did not intend that Section 10(b) be accorded the broad, remedial application consonant with other sections of the 1934 Act, because its language distinctly signified intentional misconduct.

Studying the Section's meager legislative history,²⁴ the Court found evidence that Congress did not intend one to be liable for proscribed practices unless he acted in bad faith.²⁵ Further, the Court discerned that whenever Congress provided for a negligence action in other sections of the 1933 and 1934 Acts, "significant procedural restrictions not applicable under Section 10(b)"²⁶ were included in the legislation.²⁷ Extension of

Rule 10b-5, 67 NW. U.L. REV. 562, 591 (1972); Epstein, *The Scierter Requirement in Actions Under Rule 10b-5*, 48 N. CAR. L. REV. 482, 503-04 (1970); Comment, *Scierter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1067, 1081-83 (1969); Comment, *Scierter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108, 1115 (1969); and Note, 32 U. CHI. L. REV. 824, 839 (1965).

20. 96 S. Ct. at 1389.

21. The Court was specifically concerned about the use of such terms as "manipulative," "device," and "contrivance," all of which tend to evince an element of intent. *Id.* at 1384.

22. *Id.*

23. See text and material cited at notes 7 and 9, *supra*. The Supreme Court first recognized that the securities laws could best meet their legislative purpose if construed liberally in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) and subsequently in *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). For a discussion of the function of remedial laws and the firmly established principle that such laws are to be liberally construed, see generally 3 C. SANDS, SUTHERLAND STATUTORY CONSTRUCTION, § 60.01 at 29 (4th ed. 1972).

24. See note 13, *supra*.

25. 96 S. Ct. at 1387.

26. *Id.* at 1388.

27. Specifically referred to were §§ 11, 12(2), 13, and 15 of the Securities Act of 1933 which contain restrictions in the form of posting of bond for costs, including attorneys' fees, and shortened statutes of limitations. *Id.* at 1389. Though the

Section 10(b) to negligence actions, the Court feared, would nullify the procedural restrictions applicable to other sections by allowing actions covered by those sections to be brought under Section 10(b).

Discussion of the impact of the instant case should be prefaced with a *caveat*: the decision is limited to the narrow facts of the case. The plaintiffs were private individuals suing only for damages²⁸ rather than the SEC asking for injunctive relief or damages.²⁹ The decision is also limited by the fact that the Court held that mere negligence is insufficient cause for a private plaintiff to invoke the sanctions of Section 10(b) and rule 10b-5 and required an allegation of scienter—an intent to deceive, manipulate, or defraud—without specifying the degree of culpability necessary before an individual may successfully bring an action for damages.³⁰

Despite the narrowness of the holding, the instant case is significant in two respects. First, the Court continued the current trend toward strict

implications of this decision concerning the Court's treatment of statute of limitations problems are beyond the scope of this Note, it should be mentioned that the Court seems to favor the application of state Blue Sky Laws to Section 10(b) and rule 10b-5 rather than the shorter federal statutes of limitations. *Id.* at n.29.

28. Plaintiffs did not seek an injunction in the instant case, and the Court did not address the question of whether an action for injunction by a private individual based on negligence alone would have been successful.

29. The courts have generally recognized that SEC actions in enforcing the Section and the rule should be subject to a lesser standard than private actions. In other words, an SEC action for injunction based on negligence would likely be accorded favorable treatment by the Court. However, SEC actions for damages on behalf of defrauded stockholders may not be so readily accommodated. *See, e.g., SEC v. First Securities Co.*, 463 F.2d 981 (7th cir.), *cert. denied*, 409 U.S. 880 (1972); *SEC v. Fifth Avenue Coach Lines, Inc.*, 435 F.2d 510, 517 (2d Cir. 1970). *See also* 2 BROMBERG § 8.4(585)(6)-(7) at 204.218-219; 5 JACOBS § 36 at 2-5; Comment, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1063 (1969); *but see SEC v. Bausch & Lomb, Inc.*, 1976 CCH FED. SEC. L. REP. ¶ 95,722 at 90,510. The instant case is not concerned with either an SEC action for damages or an injunction, and the Court does not indicate how it would treat such actions.

30. "In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 96 S. Ct. at 1381 n.12. The standards of conduct from most culpable to least culpable include: 1) specific intent to defraud; 2) actual knowledge that the statement made is false; 3) reckless behavior; 4) negligent behavior; and 5) innocent, non-negligent behavior. Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A. L. REV. 583, 589 (1958). The obvious implication of the Supreme Court's statement is that if there is to be a debate about the appropriate degree of scienter, it should revolve around the recklessness standard. Specific intent and actual knowledge at least seemingly fit squarely within the Court's concept of scienter.

construction of federal securities laws,³¹ which suggests that it would encourage stronger state action in the regulation of corporations and their dealings with the public.³² Second, the decision settles the controversy among the federal circuit courts³³ concerning whether a private cause of action may be based on negligence alone.³⁴ The circuits now have a foundation with which to begin their formal evolution of a scienter standard.

By limiting the decision to the facts of the case,³⁵ the Court reserved the question of how it will deal with an action alleging scienter without a *specific* intent to deceive, manipulate, or defraud. For example, the Court may be confronted with an action against a controlling stockholder who wantonly ignored evidence indicating the unfairness of a merger transaction and therefore failed to disclose the information to the other shareholders.³⁶ *Hochfelder* does not explain whether stockholders who are adversely

31. See, e.g., *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

32. ". . . [T]he state courts have not met the problem of deterioration in corporate standards. This has been notably true in Delaware where so many of the major corporations are organized." Cary, *Observations on Rule 10b-5*, 31 BUS. LAW 1703, 1704 (April 1976). One commentator has suggested that the basis for the inability of states to deal with problems in securities regulation is that state laws "are designed to apply to a wide variety of fraud situations, and cannot be expected to be flexible enough to adapt to the peculiar circumstances of securities fraud." Comment, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 670 (1965). The impact of *Hochfelder* may be to emphasize the essential dichotomy between federal and state laws. "The state is concerned with regulating and preserving the corporation, a creature of its law. By contrast, the federal interest is not focused on the corporation, but upon the securities transaction. If securities are not involved, . . . section 10(b) is not applicable, no matter how great the injury to the corporation." Note, 86 HARV. L. REV. 1007 (1973). At least three states, Illinois, New York, and California, have shown a propensity to enforce aggressively state laws regarding corporate fiduciary responsibility. See, e.g., *Jones v. H.F. Ahmanson & Co.*, 81 Cal. Rptr. 592, 460 P.2d 464 (1969); *Kerrigan v. Unity Savings Ass'n.*, 58 Ill.2d 20, 317 N.E.2d 39 (1974); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910 (1969).

33. See text and cases cited at note 16, *supra*.

34. No court which applied the negligence standard in a Section 10(b) action ever actually found for a plaintiff against a merely negligent defendant, and in most of the cases where courts found a negligence standard adequate, plaintiff's cause of action actually included a claim of defendant's culpability. See Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 569-71 (1972).

35. 96 S. Ct. at 1381 n.12.

36. The facts of this example are substantially the same as those in *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976), a case decided immediately after *Hochfelder* which construed the decision as holding that recklessness is enough to satisfy the Supreme Court scienter requirement.

affected by such *recklessness* may bring an action under Section 10(b) and rule 10b-5.

To resolve such a situation, the Court may wish to re-examine the legislative history of Section 10(b) and the administrative history of rule 10b-5 in order to ascertain the degree of culpability which Congress sought to regulate when they were enacted.³⁷ Many commentators suggest that such an examination would reveal evidence that Congress intended to enact the common-law concept of fraud, as understood in 1934, which included all forms of knowledge, including knowledge imputed to persons who act recklessly.³⁸

If the Court were to distinguish between mere negligence and recklessness sufficient to impute knowledge, it would achieve, within the constraints of congressional intent, an equitable balance between the defendant's duty to disclose adequate information and the plaintiff's burden of proof. Apparently seeking such a result, the American Law Institute has proposed that scienter be considered present when a person "knows that the matter is otherwise than as represented, . . . does not have the confidence in its existence or nonexistence that he expresses or implies, or, . . . knows that he does not have the basis that he states or implies he has for his belief."³⁹

It is axiomatic that Congress could obviate a court decision concerning the proper degree of scienter required in Section 10(b) actions by legislating a particular standard; however, the Section has survived unamended for more than four decades, and Congress seems inclined to allow the judiciary to solve such a legislative problem, at least until the American Law Institute submits its proposed Federal Securities Code.⁴⁰ Relief could also be provided by the SEC in the form of an additional rule implementing Section

37. Such an examination was unnecessary for the decision in the instant case, because the issue was whether a negligence action could be brought under Section 10(b) and rule 10b-5, not *what* degree of culpability should be requisite for a private action for damages under the Section and the rule.

38. See, e.g., Comment, *Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 670-71 (1965); Note, 63 U. MICH. L. REV. 1070, 1075-76 (1965). See generally, F. HARPER, A TREATISE ON THE LAW OF TORTS, § 221 at 453-57 (1st ed. 1933); F. POLLOCK, LAW OF TORTS, 290-315 (13th ed. 1929).

39. Federal Securities Code, Sec. 296AA, 7-8 (ALI Tent. Draft No. 3 1974). The ALI treatment of scienter provides different penalties for those with actual knowledge or intent to deceive than for those who recklessly act to the detriment of others. Loss, *Summary Remarks*, 30 BUS. LAW. 163, 166-67 (March 1975).

40. The ALI proposed Federal Securities Code is expected to be submitted to Congress sometime in 1980. *Id.* at 166.

10(b). Such a rule could define the terms of the Section by using a scheme of liability in which a higher standard of scienter would be applied to defendants like Ernst & Ernst in the instant case than to corporate representatives and others upon whom greater reliance is placed by shareholders.⁴¹ However, absent SEC rulemaking or congressional legislation, the courts must now continue the search for a uniform scienter standard.

William Deryl Medlin

PURELY COMMERCIAL SPEECH AND
ITS RELATIONSHIP TO THE FIRST AMENDMENT

In 1942, the decision of *Valentine v. Chrestensen*¹ began what was later to become known as the commercial speech doctrine. From its initial pronouncement the doctrine was consistently invoked to reject first amendment attacks upon regulation of speech in a business context.² However, in recent years the commercial speech doctrine has become subject to increasing criticism³ and was eventually overruled in *Virginia State Board of*

41. By promulgating such a rule, the SEC could maximize the remedial goals of the securities laws and at the same time avoid any impingement on the "logical growth of regulation of the securities market." *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 592 (5th Cir. 1974). For example, parties charged with the full and complete disclosure of corporate information, such as the accounting firm in the instant case, should be less amenable to suit so that the flow of information would continue. On the other hand, persons who more directly influence the decision of persons to buy and sell securities, and who have access to crucial information, should be held to a higher standard of performance. Other policy matters are considered at note 19, *supra*, and are equally relevant to the determination of the proper standard of culpability.

1. 316 U.S. 52 (1942).

2. *See, e.g.*, *Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations*, 413 U.S. 376 (1973); *Breard v. Alexandria*, 341 U.S. 622 (1951); *United States v. Hunter*, 459 F.2d 205, 211-12 & n.6 (4th Cir. 1972) ("The [commercial speech doctrine] is supported by an unbroken line of authority from the Supreme Court down which distinguishes between the expression of ideas protected by the first amendment and commercial advertising in a business context."); *Chrestensen v. Valentine*, 122 F.2d 511, 517-26 (2d Cir. 1941) (Frank, J., dissenting) (articulating the reasons for relegating purely commercial speech to unprotected status); Note, 23 DEPAUL L. REV. 1258, 1264 nn.31 & 32 (1974).

3. *See, e.g.*, *Bigelow v. Virginia*, 421 U.S. 809, 820 n.6 (1975); *Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations*, 413 U.S. 376, 393, 398, 401 (1973) (three separate dissents); Redish, *The First Amendment in the Marketplace: Commercial Speech and the Values of Free Expression*, 39 GEO. WASH. L. REV. 429 (1971); Note, 61 CORNELL L. REV. 640 (1976).