The Extension of a Private Remedy to Defrauded Securities Investors Under Sec Rule 10B-5

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I. INTRODUCTION: FRAUD AT THE COMMON LAW

In the years prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, fraud in the purchase and sale of securities was governed by the principles applicable to the common law action of deceit, unless the fraudulent transaction fell within the confines of some other federal statute which only coincidentally touched transactions in securities. To the extent that the concept of "fraud" under the Acts of 1933 and 1934 could not have been born in a vacuum and must have been conceived with an eye to the principles governing at the common law, a brief inspection of those concepts must be undertaken.

In order to state a cause of action for deceit at common law, the plaintiff was required to allege and prove the following: (1) a false representation of a material fact made by the defendant; (2) scienter, or knowledge on the part of the defendant that his statement was false, or at least the absence of a sufficient basis of information on which to

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1. 15 U.S.C. §§ 77a-aa (1958) [hereinafter referred to as the Securities Act].
3. Thus, for example, one who through the use of the mails fraudulently induced the purchase or sale of a security would be subject to criminal liability under the general mail fraud statute. 18 U.S.C. § 1341, formerly 18 U.S.C. § 338 (1940).
4. For a sampling of cases wherein securities transactions were held to involve the mail fraud provisions, see the following: United States v. Grayson, 166 F.2d 863 (2d Cir. 1948); Foshay v. United States, 68 F.2d 205 (8th Cir. 1933), cert. denied 291 U.S. 674 (1934); Stephens v. United States, 41 F.2d 440 (9th Cir. 1930), cert. denied 282 U.S. 880 (1930); United States v. Hersey, 288 Fed. 852 (D. Mass. 1923); Pandolfo v. United States, 286 Fed. 8 (7th Cir. 1922), cert. denied 261 U.S. 621 (1923).
5. A fact may be defined as "material" if "its existence or nonexistence is a matter of which a reasonable man would attach importance in determining his course of action in the transaction in question." Restatement, Torts § 538(2) (1934).
6. Under the Exchange Act, the term "material" is limited to "those matters as to which

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make it;\(^6\) (3) an intention to induce the plaintiff to act or to refrain from acting in reliance on the statement; (4) justifiable reliance upon the statement on the part of the plaintiff;\(^7\) and (5) damage to the plaintiff as a consequence of his reliance.

The scope of the protection available under the common law was set forth in the leading case of *Peek v. Gurney*.\(^8\) In that case, the directors of a corporation issued a false prospectus for the purpose of inducing the public to purchase stock from the corporation. In denying recovery to an investor who had purchased the stock on the open market and not from the individual defendants directly, the court limited responsibility to those persons whom the defendants had *intended to induce*. Although *Peek v. Gurney* has been accepted by the Restatement of Torts,\(^9\) and at the present time still appears to be the majority view, recent years have witnessed a tendency away from the traditional view and towards the extension of liability to those persons whose reliance on the representation might reasonably have been anticipated.\(^10\) Even under the traditional view, however, strict privity of contract between the parties does not seem to be a requisite. On the other hand, to the extent that direct privity wanes in importance, the element of reliance upon the false representation would seem to wax more significant, especially in the case where the only nexus between the defendant's misrepresentation and the plaintiff's injury is the latter's reliance on the false statement. As will be seen later, the two concepts of privity and reliance pose important and still not fully resolved issues under the federal statutes.\(^11\)

Finally, under the traditional common law view of deceit, a cause of action would lie only in the case of affirmative untruths on the part of the defendant. Under the more modern common law theory, an action for

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\(^6\) For a more comprehensive treatment of the intent necessary to result in liability, see Prosser, *op. cit. supra* note 4, at 537-49.

\(^7\) Generally, the requirement of justifiable reliance is closely tied to the requirement that the fact misrepresented be a material one. Prosser, *op. cit. supra* note 4, at 554.

\(^8\) The fact that the plaintiff might have ascertained the falsity of the representation by an investigation is not inconsistent with reliance on its truth. *Restatement, Torts* § 540 (1934). However, actual knowledge by the plaintiff that the representation is false precludes a finding of reliance. *Restatement, Torts* § 538, comment (c) (1934). Similarly, if the falsity of the representation is obvious, reliance will not be considered justified. *Restatement, Torts* § 541 (1934).

\(^9\) See section V(C) of this paper's text, *infra*. 


\(^{11}\) See section V(C) of this paper's text, *infra*. 

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deceit also encompasses a half-truth, which is held to be as much a mis-
representation as if the facts stated were untrue.12 However, even today
there is no common law liability for complete nondisclosure, unless one
party to a business transaction prevents the other by concealment from
acquiring material information13 or unless the parties occupy a fiduciary
relationship which imposes a duty of disclosure.

II. THE EXPRESS CIVIL LIABILITY PROVISIONS
UNDER THE FEDERAL ACTS

The year 1933 tokens the first significant milestone in the law of
American securities legislation. In the Securities Act of 1933, the Congress
inaugurated a complex, comprehensive system for the registration and
issuance of securities through the use of the mails or facilities of inter-
state commerce. In order to carry out more fully its goal of protecting the
public from misleading statements and material omissions in the sale of
securities, Congress blended the elaborate registration requirements with
provisions for the imposition of civil and criminal liability upon persons
selling securities in violation of the Act. In order to place the provisions
of section 10(b) of the 1934 Act and Rule 10b-5 in their proper per-
spective, a brief glimpse of the civil liability provisions of the 1933 Act
will prove worthwhile.

Civil liability under the 1933 Act may arise under three sections of
the statute. Section 1114 permits the purchaser of a security that has
been registered under the Act to sue the issuer and certain other desig-
nated individuals for an untrue statement of a material fact or for an
omission to state a material fact required to be stated or necessary to
prevent the statements in the registration statement from being mislead-
ing. By its express language, section 11 provides a remedy to “any person
acquiring such security” and is not limited to those persons in direct
privity of contact with the issuer, provided the purchaser had no knowl-
dge of the untruth or omission at the time of his acquisition of the
security. A right of action may also be predicated on reliance by the pur-
chaser upon an earnings statement covering a one-year period after the
effective date of the registration statement, if the plaintiff purchased his
shares after the issuance of the statement. Persons other than the issuer
who are otherwise liable under section 11 may exonerate themselves if
they can sustain the burden of proving that they had no knowledge of
the facts which constituted the alleged violations. Moreover, under
section 11 and “any other section of this title,” the trial court is vested
with discretion to require that the plaintiff furnish an undertaking for

deciet action, in which misleading statements in a prospectus were allegedly made).
the costs of the suit, including reasonable attorney's fees. Finally, a purchaser may sue under section 11 either at law or in equity, in any court of competent jurisdiction, and the defendants may be held jointly and severally liable.

Section 12 imposes civil liability on two classes of sellers: those who sell unregistered securities in violation of section 5, and those who sell securities whether or not they are required to be registered by means of a prospectus or oral communication containing an untruth or an omission to state a material fact. The seller may defend by showing that the purchaser knew of the untruth or omission or that the seller did not know and could not, in the exercise of reasonable care, have known of the untrue statement or omission. However, the defendant's liability extends only to the person who purchased the securities directly from him; in short, privity of contract between the plaintiff and the defendant is required.

Both sections 11 and 12 are governed by the relatively short statute of limitations furnished by section 13. Thus, an injured purchaser must bring his action within one year after discovering the untrue statement or omission, but in no event may he bring the action if more than three years have elapsed since the offer or sale occurred.

Section 17(a) declares that "it shall be unlawful" for any person who offers or sells securities by use of the mails or facilities of interstate commerce to employ any device or scheme to defraud, to make an untrue statement or omit to state a material fact, or to engage in transactions or practices which operate as a fraud on any purchaser. Although section 17(a) simply proscribes certain conduct as "unlawful," it has been construed by some courts as furnishing an implied civil remedy for the defrauded purchaser of securities.

At this juncture, it should be apparent that all three sections of the Securities Act providing either an express or implied civil right of action offer relief exclusively to the injured purchaser of securities. Aware of the fact that persons might just as easily be defrauded into selling securities, Congress sought to bring sellers into a position of equality with defrauded purchasers through the enactment of the Securities Exchange Act of 1934. Thus, section 9(a) of the 1934 Act declares it unlawful for "any person" to engage in certain defined manipulative practices with respect to securities listed on a national exchange. By virtue of section

9(e), defrauded purchasers and sellers may bring a civil action against any person willfully participating in conduct proscribed by section 9(a). As mentioned, however, the protection does not extend to transactions in unlisted securities, and the plaintiff is entitled to recover only if he can demonstrate that the price at which he purchased or sold was "affected by" the defendant's manipulation. Furthermore, in such actions the court is vested with discretion to require an undertaking by the plaintiff for costs and attorney's fees, as under the 1933 Act. Finally, unlike most of the other civil liability sections of the 1933 and 1934 Acts, transactions in securities exempted from the registration requirements of the Securities Act are excluded from civil liability under section 9.

Section 15 extends civil liability to brokers and dealers who carry out fraudulent purchases and sales of unlisted securities by the means of the mails or facilities of interstate commerce.

Section 16(b) provides that certain corporate "insiders" are liable for short-swing profits realized from any purchase and sale or sale and purchase of any equity security of an issuer whose stock is listed on a national exchange. However, recovery inures to the corporation rather than to the individual shareholder, creating a kind of statutory derivative action.

Finally, the Exchange Act includes a potentially comprehensive anti-fraud provision, section 10(b), which declares unlawful manipulative or deceptive devices "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."

When viewed as an integrated body of securities regulation, it was soon apparent that the 1933 and 1934 Acts still failed to provide equal protection to defrauded purchasers and sellers of securities. While the express civil liability provisions of the 1933 Act, fortified by the implied protection embodied in section 17(a), afforded virtually complete protection to the defrauded purchaser, the defrauded seller was left vulnerable in a number of critical areas. Thus, although section 9(e) provided a civil right of action to both buyers and sellers injured by manipulative practices, the burden imposed on the plaintiff was almost unbearable, which may explain why so few actions have been brought under that

23. The trial court is further authorized to assess reasonable costs, including reasonable attorneys' fees, against either party litigant.
24. In one notable exception, § 12(2) of the Securities Act expressly exempts securities of a governmental issuer from the scope of its civil liability.
Although section 15(c)(1) and the rules promulgated thereunder extend protection to buyers and sellers alike, the fraud must be perpetrated by brokers or dealers, and then only with respect to securities sold in the over-the-counter market. And, as noted previously, the recovery provided by section 16(b) for short-swing profits inures to the corporation and not to the injured shareholder.

From the midst of this patchwork quilt of sellers' protection emerged the Securities and Exchange Commission's Rule X-10b-5, now designated simply as Rule 10b-5. Although the contours of section 10(b) were extremely broad, it was not self-executing and required the adoption of rules by the Commission. Pursuant to the congressional delegation of authority, on May 21, 1942, the SEC adopted Rule 10b-5, which reads as follows:

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,

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

(2) 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

(3) 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.

At first glance, Rule 10b-5 seems to have been lifted verbatim from section 17(a) of the Securities Act. In both cases, the same acts, practices, schemes and misrepresentations are declared unlawful. However, whereas section 17(a) applies only to unlawful acts by persons who offer or sell securities, Rule 10b-5 extends to "any person" who "directly or indirectly" engages in certain proscribed conduct "in connection with the purchase or sale of any security." Thus, in one broad stroke of the administrative pen—a stroke admittedly shortened by the availability of section 17(a) as a model—the Commission ventured to extend to the defrauded seller the wide protection it previously had afforded only the purchaser under the 1933 Act. With scarcely more than 110 words, the Commission attempted to plug the gaping holes in sellers' protection which remained after the express liability provisions of the Exchange Act had been

enacted. There is little reason to doubt that this was the Commission's intention, for on the same day that the rule was announced, the Commission declared:

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase . . . .

Despite the broad language of the new rule and the so-called "loopholes" it purported to close, the argument that Rule 10b-5 had at last equalized the treatment of buyers and sellers under the federal acts was less than convincing. Although the admittedly objectionable activities of securities purchasers were declared "unlawful," no express civil right of action was mentioned in the rule, as the buyer had been afforded by virtue of the 1933 Act and as a few limited classes of buyers and sellers had been granted under the 1934 Act. The protection the seller had awaited for eight years had arrived, but it seemed to be an illusory one at best.

III. The Kardon Doctrine: The Genesis of a Civil Right of Action

In 1946, the courts were called upon for the first time to consider whether Rule 10b-5 could be relied on as the basis for a private right of action. In Kardon v. National Gypsum Co., the Slavin brothers, who owned one-half of the stock of the Western Board and Paper Company, entered into a contract on behalf of the corporation for the sale of its assets to the National Gypsum Company for one and one-half million dollars. A short time later, the Slavins entered into another contract with the Kardons, the remaining shareholders of Western, to purchase the Kardons' stock in that company for 504,000 dollars. No mention of the contract with National Gypsum was made at any time, and at the closing, when the plaintiffs inquired whether any such contract had been executed, the Slavins answered in the negative. The plaintiffs brought a civil action under Rule 10b-5 and the defendants moved to dismiss on the ground that Rule 10b-5 did not encompass the plaintiffs' cause of action. The court denied the defendants' motion and permitted recovery under two alternative theories: the statutory tort doctrine and the voidability of contracts doctrine embodied in section 29 of the Exchange Act.

As early as 1916, long before the first federal securities legislation, the United States Supreme Court had recognized that "a disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose special benefit the statute was enacted, the right to recover damages from the party in default is implied . . . ."38 This doctrine of statutory torts was recognized by the text writers even earlier34 and affirmed by the Supreme Court as recently as one year before the Kardon decision.39 The doctrine is accepted by the Restatement of Torts,35 which was quoted favorably by the district court in Kardon.

The defendants pointed to other sections of the Exchange Act which expressly granted a civil remedy to defrauded sellers, relying on the maxim of statutory construction, expressio unius est exclusio alterius.37 The court replied:

The argument is not without force. Were the whole question one of statutory interpretation it might be convincing, but the question is only partly such. It is whether an intention can be implied to deny a remedy and to wipe out a liability which, normally, by virtue of the basic principles of tort law accompanies the doing of the prohibited act. Where, as here, the whole statute discloses a broad purpose to regulate securities transactions of all kinds and, as a part of such regulation, the specific section in question provides for the elimination of all manipulative or deceptive methods in such transactions, the construction contended for by the defendants may not be adopted. In other words, in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.38

Realizing that the court was willing to imply a civil remedy by use of the statutory tort doctrine, the defendants attempted to escape liability by arguing that the plaintiffs were not within the class of persons, "investors," that Congress had intended to protect by section 10(b). Judge Kirkpatrick countered, "I cannot agree, however, that 'investors' is limited to persons who are about to invest in a security or that two men who have acquired ownership of the stock of a corporation are not investors merely because they own half of the total issue."39

[W]here federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief.
36. Restatement, Torts § 286 (1934).
39. Ibid.
In addition to fashioning an implied civil action out of the statutory tort doctrine, the court found in the alternative that relief might also be predicated on section 29(b) of the Exchange Act, which provides that contracts in violation of any of the provisions of the 1934 Act are void.

Since the *Kardon* decision in 1946, the doctrine of implied liability under section 10(b) and Rule 10b-5 has been recognized by five federal circuits and ten district courts. The general principle has been so widely recognized that in the more recent cases the defendant no longer bothers to assert in his defense that the seller has no right of action under section 10(b).

In addition to the arguments set forth by Judge Kirkpatrick in *Kardon*, the federal courts have advanced several other reasons to justify the implication of civil liability under section 10(b) and Rule 10b-5. Some courts have looked to the purposes of Congress in enacting the Exchange Act, particularly the desire to lessen fraudulent practices in the securities market, arguing that nothing would more effectively deter the proscribed activities than the availability of a private remedy by the defrauded purchasers and sellers. It has also been urged that, in vesting jurisdiction in the federal courts to determine violations of the statute and the rules promulgated thereunder, section 27 of the Exchange Act does not exclude from the term “violations” a civil suit by a defrauded purchaser or seller. One writer has argued that when Congress amended the 1934 Act to provide a three-year statute of limitations for actions brought under section 15(c)(1), which itself granted no express civil relief, its action in ignoring section 10(b) demonstrated its recognition that an implied civil action had always existed under the latter section.
equally plausible, however, that Congress failed to include in its amend-
ment a statute of limitations applicable to section 10(b) simply because
it did not consider a civil right of action to be available thereunder.

IV. THE BUYER'S RIGHT OF ACTION UNDER RULE 10b-5

The coincidence of a number of factors made the implication of a
private right of action in favor of sellers under Rule 10b-5 relatively
easy to accept. When one considers the inequality of remedies which were
available to buyers and sellers under the two Acts, along with the policy of
the courts to imply a private remedy for the violation of a statute, it
does not offend one's concept of the separation of powers when a court
implies, as it did in the Kardon case, a right of action not expressly be-
stowed by Congress. However, when the courts are asked to imply a
corresponding right of action in favor of an injured purchaser, serious
difficulties are encountered which are not susceptible of the same facile
solution. In view of the comprehensive express liability provisions in
favor of the purchaser afforded by the two acts, it might be asked why
the purchaser is attracted to Rule 10b-5?

Although the 1933 Act extends relief to the injured purchaser of
securities under a wide variety of circumstances; his remedies are sur-
rounded by a wall of restrictions not mentioned in Rule 10b-5. The most
preclusive of these is the one-and-three year statute of limitations gov-
erning suits brought pursuant to sections 11 and 12 of the Securities
Act. On the other hand, neither section 10(b) nor Rule 10b-5 make
reference to a period of limitation; consequently, the courts are directed
by the conflicts principle which calls for the application of the statute
of limitations of the forum.45 In most cases, this period is five or six years,
or roughly twice as long as the period governing an action brought
under the 1933 Act.

45. In the following cases arising under Rule 10b-5, the federal court expressly applied
the statute of limitations of the forum: Errion v. Connell, 236 F.2d 447 (9th Cir. 1956)
(Washington 3 year statute); Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 143 F.
Supp. 323 (D. Del. 1956) (Delaware statute applied, though action was barred by laches);
Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952) (Illinois
5 year statute); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949) (New York 6 year
statute). See also Trussell v. United Underwriters, 236 F. Supp. 801 (D. Colo. 1964), where
the district court also applied the forum's borrowing statute.

The difference between the local period of limitations and the short statute under the
1933 Act is widened even further by the fact, as these cases point out, that the state
statute of limitations does not even begin to run until such time as the fraud is discov-
ered. Under the mandate of § 13 of the Securities Act, the action is barred unless it is brought
within one year after the fraud has been discovered, and in no event may an action be
maintained more than three years after the violation has occurred. Thus, if a plaintiff
discovers the deception four years after it has been perpetrated, his action will be sum-
marily barred by § 13, while he is permitted to maintain his action under Rule 10b-5 until
the tenth year after the violation, assuming the usual six year statute of limitations.

For a comprehensive discussion of the guidelines which govern the federal courts
in such cases, see 3 Loss, Securities Regulation 1771-77 (2d ed. 1961). See also Comment,
59 Yale L.J. 1120 (1950).
Second, the Securities Act of 1933 permits the defendant-seller to interpose certain affirmative defenses, such as knowledge or the absence of reliance on the part of the purchaser, while Rule 10b-5 contains no such provision. Moreover, whereas section 12 of the 1933 Act requires privity of contract between the plaintiff and defendant, Rule 10b-5 proscribes certain conduct by "any person" and "in connection with the purchase or sale of any security." However, as will be seen later, the requirement of privity under the rule has not been dispensed with entirely.\(^4\) Finally, the grant of authority to trial judges in cases arising under the Securities Act to require the plaintiff to furnish an undertaking for costs and attorney's fees is nowhere mentioned in section 10(b) or Rule 10b-5, although the same authority has been vested in the trial judge by other sections of the Exchange Act.\(^4\)

Thus, as Professor Loss points out, "it is not too surprising . . . that astute counsel soon attempted to claim for buyers the cultivated pearl which is the Kardon doctrine."\(^4\) As will be seen shortly, the courts were confronted with considerably more than the mere "application" of the Kardon principle to purchasers. Forgetting for the moment the more subtle arguments both for and against the implication of a private action in favor of purchasers under Rule 10b-5, the problem resolves itself into the confrontation of two concepts which are as deeply impregnated in the two acts as they are contradictory. On the one hand, section 10(b) and Rule 10b-5 expressly apply to "any person" and not simply to fraud in the purchase of securities. On the other hand, the 1933 Act had already bestowed remedies upon the injured security purchaser for a wide variety of wrongs, while at the same time it had surrounded those remedies with a well-defined code of procedure. It is obvious, therefore, that the availability of a private right of action to purchasers under Rule 10b-5 invites evasion of the limitations imposed on the buyer's right of action by the express provisions of the Securities Act. If, however, the purchaser is denied the same unrestricted right of action under the rule that the seller was given by Kardon, the latter is left in a far more advantageous position than the purchaser, who was clearly favored over the seller in the 1933 Act.

Recognizing that the 1933 and 1934 Acts, when viewed together, pose "certain inescapable anomalies, no matter which of the several alternative constructions are placed in section 10(b),"\(^7\) the majority of courts that have considered the problem have permitted the defrauded buyer a right of action coextensive with that afforded the defrauded seller of securities by the Kardon and subsequent decisions. Before these decisions are analyzed, however, it is appropriate to examine the various

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46. See section V(C) of this paper's text, infra.
47. Exchange Act §§ 9(e) and 18(a).
48. 3 Loss, SECURITIES REGULATION 1780 (2d ed. 1961).
49. Ellis v. Carter, 291 F.2d 270, 273 (9th Cir. 1961).
alternatives available to the courts in seeking to resolve what appears, in reality, to be a judicially insoluble problem.⁵⁰

First, a court might deny a private right of action to both purchasers and sellers alike on the ground that the two acts, both individually and when viewed as an integrated body of legislation, were drafted too closely to permit private actions beyond those expressly provided. Although logically this may be commended as the most uncomplicated way of resolving the anomalies, as a practical matter it would seem objectionable on several grounds. For one thing, the Kardon doctrine of implied civil liability has been so widely accepted in the case of defrauded sellers that it would be extremely difficult, and more than a little embarrassing, for the courts to repudiate the elaborate system of rationalizations they have constructed in support of the rule. Moreover, under such a construction the defrauded seller, who was the principal beneficiary under Rule 10b-5, would again find himself without an effective remedy, while the defrauded purchaser would remain fully protected by the 1933 Act. At the price of logical consistency, the courts would, in effect, be throwing out the proverbial baby with the bath water. As the Ninth Circuit noted in Ellis v. Carter,₅¹ solution of the problem by choosing the first alternative "seems inconsistent with the all-embracing scope of the legislation and requires that an unexplained distinction be drawn between buyers and sellers."₅² At the present time, no court has elected to pursue this alternative.

As a second alternative, the courts might permit sellers alone a right of action under section 10(b) and Rule 10b-5, consistent with the apparent intent of the commission in seeking to close the loopholes which plagued the sellers' remedies. This alternative appears to have been chosen by several courts and was the solution reached by the first case to consider whether the purchaser was entitled to an implied remedy under Rule 10b-5. In Montague v. Electronic Corp.,₅₃ the plaintiffs sought to recover for injuries occasioned by false and misleading statements contained in a registration statement filed by the defendant. The plaintiffs' original complaint alleged that both section 11 of the Securities Act and section 10(b) of the Exchange Act had been violated. When the defendant moved to dismiss or, in the alternative, to require the plaintiffs to furnish an undertaking for costs pursuant to section 11, the plaintiffs amended their complaint to allege a single cause of action under section 10(b). Recognizing that the Kardon case had permitted a defrauded seller to maintain an action under section 10(b) and Rule 10b-5, Judge Coxe nevertheless refused to extend the principle to the plaintiff-purchasers.

⁵⁰ See Ellis v. Carter, supra note 49, where the court outlines the four possible alternatives and the virtues and objectionable features of each choice.
⁵¹ 291 F.2d 270 (9th Cir. 1961).
⁵² Id. at 273.
In urging that neither section 10(b) nor Rule 10b-5 were intended to supplant section 11 of the Securities Act, he pointed out that section 11 related to a limited special subject, while section 10(b) was framed in general language, reasoning that his decision must be governed by the settled rule of statutory construction that

where there is a special statutory provision affording a remedy for particular specific cases and where there is also a general provision which is comprehensive enough to include what is embraced in the former, the special provision will prevail over the general provision, and the latter will be held to apply only to such cases as are not within the former. . . .

Implicit in Judge Coxe's reasoning, however, is the suggestion that section 10(b) and Rule 10b-5 should not be construed as categorically precluding a private action by a defrauded purchaser, for as long as no coextensive remedy is afforded the purchaser under the express provisions of the two acts, in the proper case Rule 10b-5 might be resorted to in order to close the loopholes in the mantel of protection surrounding the securities purchaser.

A short time after the decision in Montague, the same judge who had permitted a civil action under Rule 10b-5 in Kardon denied the existence of a corresponding right in the purchaser. In Rosenberg v. Globe Aircraft Corp., the plaintiff-purchasers alleged, using the phrasing of Rule 10b-5, that the defendants had employed schemes and devices to defraud them into purchasing securities. In reality, the alleged untruths had occurred in the defendant's registration statement. Without deciding whether a fraudulent registration statement might constitute a special type of manipulative or deceptive device, the court held that the plaintiff's cause of action arose exclusively from conduct violative of sections 11 and 12 of the Securities Act, and consequently the venue provisions of the 1933 Act would govern the action. Judge Kirkpatrick was unwilling to consider the possibility that Congress had intended the remedies under the 1933 Act and section 10(b) to be concurrent:

The two Acts are unquestionably in pari materia and must be construed together to make a consistent whole. Looking at them as one statute it is simply not possible that Congress, having prescribed in elaborate detail procedural requirements which must be fulfilled in order to enforce civil liability attaching to a carefully defined type of violation, would have casually nullified them all in a later section. . . . No other interpretation can avoid making a completely incongruous piece of legislation out of the two statutes in question. . . .

54. Id. at 936. Since § 11 of the Securities Act was held to apply to the exclusion of all other provisions, the court required the plaintiffs to furnish an undertaking for costs and attorney's fees.


56. Id. at 124-25. But see Ellis v. Carter, 291 F.2d 270, 273-74 (9th Cir. 1961), where
Although the construction given to section 10(b) by the New York and Pennsylvania district courts is sustainable as a practical means of solving the problem, it flies in the face of the wording of section 10(b) itself, which by its terms applied equally to purchasers and sellers.

As a third alternative, it has been suggested that although section 10(b) and Rule 10b-5 might be construed as permitting a buyer to sue thereunder, his right should be subject to the same restrictions which circumscribe his rights under the 1933 Act. Admittedly, this compromise avoids the anomaly of providing the purchaser with a less restricted right than he is given by the 1933 Act; however, on closer inspection it is obvious that such a compromise in effect gives the defrauded purchaser no remedy under the 1934 Act, once again raising a distinction between buyers and sellers contrary to the express language of section 10(b).

Under the fourth alternative, a court might provide the same unrestricted right of action under the Exchange Act as sellers were granted by Kardon. On the grounds of pure simplicity, this alternative would seem to be the most desirable, for it isolates section 10(b) and Rule 10b-5 from the express liability provisions of the two acts, and thus avoids the anomalies which appear when those provisions are considered alongside Rule 10b-5. In point of fact, most of the cases permitting the purchaser to sue under Rule 10b-5 have chosen this fourth alternative.57

In 1949, one year after the New York district court decided the Montague case adversely to the plaintiff-purchaser, Osborne v. Mallory,88 permitted a buyer to recover, notwithstanding the fact that the facts alleged would have stated a cause of action under section 12(2) of the Securities Act but for the fact that the short statute of limitations had run. The action was allowed under the longer New York statute of limitations, since section 10(b) does not contain any limitations period. Instead of explaining why the plaintiff should be permitted to finesse the statute of limitations applicable to section 12, Judge Leibell simply cited the Kardon case, which, of course, involved an action by a defrauded seller.59 Ironically, neither the Montague nor the Rosenberg cases were cited in the Osborne opinion.

The most important case of this period, however, was the Second Circuit's decision in Fischman v. Raytheon Mfg. Co.,60 which reversed

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59. The same techniques were employed in Baron v. Shields, 131 F. Supp. 370 (S.D.N.Y. 1954).
60. 188 F.2d 783 (2d Cir. 1951).
a lower court determination based on Montague and Rosenberg to the effect that the plaintiff's action would lie only under the 1933 Act. In Fischman, preferred and common shareholders sued to recover for injury sustained because of certain false and misleading statements contained in a registration statement covering the defendant's preferred stock. It is apparent that the common shareholders would have no cause of action under section 11 of the Securities Act, since a suit pursuant to that section may be maintained only by one who purchases securities that are the direct subject of a prospectus and registration statement. The trial judge had reasoned that Congress did not intend to afford the common shareholders a remedy under the 1934 Act for the very conduct not actionable under the Securities Act of 1933. In reversing the trial court, Judge Frank explained that in exchange for his freedom from the restrictions imposed by the Securities Act, the purchaser suing under the Exchange Act was put to the burden of proving fraud, a requirement not present in the 1933 Act. Thus viewed, it could not be charged that the two acts provided concurrent remedies for identical wrongful conduct: 61

We think that when, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10(b) of the 1934 Act and the Rule, at the suit of any defrauded person, whether or not he could maintain a suit under § 11 of the 1933 Act.

Taking issue with the defendant's position, Judge Frank cited an example whereby section 11, which was designed to protect investors when there is no fraud, would instead afford a shelter to those who defrauded investors: 62

A corporation and its "insiders" put out a prospectus and registration statement, relating to a very small issue of preferred, which apparently complies with the provisions of the 1933 Act but which, as they well know, is false; this they do with the successful aim of fraudulently inducing some investors to purchase the preferred from the company but also other investors to purchase a much larger amount of the company's common from the "insiders." The fraud-doers would be delighted to reimburse the purchasers of the small amount of the preferred and to avoid liability to the defrauded purchasers of the large amount of the common. If the position taken by the defendants in the instant case were correct, the defrauded purchasers of the common in the illustrative case would have no redress whatever under the statute. This position we think untenable.

It is evident, therefore, that far from viewing the plaintiff's remedies under Rule 10b-5 and the 1933 Act as concurrent, Judge Frank has

61. Id. at 786-87. However, it is open to question whether the plaintiff is even required to prove affirmative fraud on the part of the defendant. See section V(B) of this article's text infra.
62. Id. at 787.
conceived two separate remedies for two different types of wrongdoing. His analysis may be justified if the conduct which violates Rule 10b-5 is that conduct proscribed by clauses (1) and (3), which speak in terms of fraud. However, the language of clause (2), which relates to untruths, misstatements and omissions, approaches more closely the language which defines conduct unlawful under the 1933 Act, and it is open to serious question whether the violation of clause (2) of the rule requires proof of fraud. If it does not, then the problem of a coextensive remedy under Rule 10b-5, free of the restrictions imposed by the Securities Act, reappears as a genuine problem which Judge Frank would be hard pressed to distinguish away.

Since the Second Circuit's decision in *Fischman v. Raytheon Mfg. Co.*, two other circuits and a number of district courts have elected the fourth alternative and have recognized the right of a defrauded buyer to sue under section 10(b) and Rule 10b-5 free of the restrictions imposed by the Securities Act. While some courts have been content simply to cite *Kardon* and other cases recognizing the seller's right under Rule 10b-5, and then to point to the language of the rule which applies without reservation to buyers and sellers alike, a few decisions still express a lingering concern for the anomalies posed when the purchaser is afforded a free and unfettered right of action. One particular group of cases demonstrates the manner by which one court has treated the problem.

In four cases arising out of the same factual pattern, purchasers of bonds issued by a local bridge authority in Nebraska sued under section 10(b) and Rule 10b-5, alleging that they were induced to purchase the bonds by certain untrue and misleading statements contained in the issuer's prospectus and in a traffic report which painted a glowing picture of the future revenue of the bridge. The defendants argued that section 12(2) of the Securities Act, which exempted from liability transactions in securities issued by a governmental subdivision, was applicable to the exclusion of all other sections of the two acts. Applying a rationale similar to that employed by Judge Frank in *Fischman*, the court argued that governmental issuers were exempt from liability only for negligent misrepresentations, which would not be actionable under Rule 10b-5. However, the court went on, the fact that Congress intended to

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63. Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960).
exempt such issuers from civil liability for negligent misrepresentations did not mean that such issuers were meant to escape liability under the Exchange Act for willful misstatements. Although this argument seems plausible as far as it goes, its vice lies in the fact that it does not go far enough. Once again the court appears to have ignored fully one-third of Rule 10b-5, namely, clause (2), which seems broad enough to include liability for misrepresentations and omissions that are wholly negligent. Following the court's reasoning to its logical conclusion, section 12(2) and not Rule 10b-5 must prevail to sustain the governmental exemption in situations in which the misrepresentation is not willful. This leads to the result that although no blanket distinction should be drawn between buyers and sellers under Rule 10b-5, nevertheless an even finer distinction must be drawn within the class of purchasers itself, namely, those who are willfully and those who are negligently defrauded—which gives birth to an anomaly far more difficult to explain.

In retrospect, the root of the dilemma lies not in the use of the words "any person" in section 10(b) and Rule 10b-5 but, rather, in the Kardon decision itself, for once a private remedy is afforded a defrauded seller, the language of the rule itself compels equal treatment of defrauded purchasers. Professor Loss suggests that if and when the Supreme Court considers the question, it would not be surprising if it chose the first of the four alternatives and overruled the Kardon principle. His thesis is predicated on the proposition that Kardon, in freeing the seller of the restrictions surrounding the buyer under the Securities Act, actually placed the "step child" of Congress, the seller, in a considerably more advantageous position than Congress had accorded the "favorite son" purchaser under the 1933 Act.

Since Professor Loss' words were penned, two important cases have been decided which cast considerable doubt upon his prognostication. In Cady, Roberts & Co., the Commission in an administrative proceeding suspended the defendant's trading privileges when it sold securities without disclosing material information which it knew would be made public within a matter of minutes. The Commission emphasized that it could envision no valid reason why securities purchasers should not be accorded the same protection as given to sellers. Admittedly, Cady,

66. In Thiele v. Shields, supra note 65, at 419-20, the court pointed out that even if the plaintiff's allegations were predicated solely on untruths contained in a prospectus or oral communication within the municipal bond exemption of § 12(2), a claim under §§ 17(a) and 10(b) would still be sustainable if knowing or intentional misrepresentation with regard to municipal bonds were alleged (and proven) by the plaintiff. That Congress intended to exempt a seller of municipal bonds from liability for failure to prove that he exercised reasonable care in investigating the truth of a representation is not inconsistent with the subjectio to civil liability of the same seller after the purchaser proves that he knowingly misrepresented a fact. (Emphasis added.)
67. 3 Loss, SECURITIES REGULATION 1790 (2d ed. 1961).
69. It is interesting to note that Professor Cary, who as Chairman of the SEC wrote
Roberts & Co. was not a private action brought by a defrauded purchaser; however, in a footnote the Commission noted that in 1951 it had struck the narrowing words, "by a purchaser," from the title of Rule 10b-5. It would be unreasonable to suggest that by changing the title the Commission intended for the rule to apply to purchasers as well as sellers only in the case of administrative proceedings, since the Commission must have been aware, in 1951, of those cases which had already recognized the existence of a private remedy under Rule 10b-5.

The other case, SEC v. Capital Gains Research Bureau, Inc., is especially significant for its broad interpretation of federal securities legislation and because it was decided by the Supreme Court. In that case, the Court read into section 206 of the Investment Advisers Act a duty of disclosure identical with that appearing expressly in clause (2) of Rule 10b-5 and section 17(a) of the provision even though only the equivalents of clauses (1) and (3) were included. Although the precise issue before the Court was the proper construction to be given to the Advisers Act, this in turn depended on the scope of section 17(a) of the 1933 Act and of securities legislation in general. In construing the language of the Advisers Act to be commensurate with the policy of complete investor protection, the Court left no room to doubt that it will give a construction to Rule 10b-5 that is at least as broad, since the rule is more nearly identical in terms to section 17(a) than is section 206 of the Advisers Act. Finally, it should be noted that in permitting the plaintiff to recover in the Capital Gains case, the Supreme Court did the opinion in Cady, Roberts & Co., suggested in his text that Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), marked the "outer limits" of Rule 10b-5—i.e., the Rule is broad enough to accommodate a right of action as long as the plaintiff is either a purchaser or seller of a security. Baker & Cary, Corporations 574 (3d ed. 1958).

A recent decision seems to have sustained Professor Cary's thesis. In Keers & Co. v. American Steel & Pump Corp., 234 F. Supp. 201 (S.D.N.Y. 1964), the court held that to be entitled to recover under Rule 10b-5, the plaintiff must be more than an "aborted" buyer or seller, i.e., one who but for the defendant's action would have been a buyer or seller.

On the other hand, in M. L. Lee & Co. v. American Cardboard & Packaging Corp., CCH Fed. Sec. L. Rep. ¶ 91,408 (E.D. Pa. June 30, 1964), the court held, in effect, that an "aborted" seller could recover under the rule. In that case, the plaintiff and defendant entered into a contract whereby the plaintiff was to sell its stock to the defendant-underwriter. The public offering never took place, the failure allegedly caused by the defendant's lack of diligence. The plaintiff charged that the defendant's promises, assurances and overall conduct constituted a course of business which operated as a fraud or deceit. The court held that even in the absence of a consummated purchase or sale, the plaintiff was entitled to maintain an action under Rule 10b-5, on the ground that the Act defined both "purchase" and "sale" to include contracts to purchase or sell. The court distinguished Birnbaum on the ground that in that case the plaintiff was not even an intended buyer or seller.


not seem the least troubled by the fact that the section relied on failed expressly to provide for a private right of action.

V. THE SCOPE OF THE RULE

In addition to the most fundamental question posed by section 10(b) and Rule 10b-5—whether an aggrieved purchaser or seller is permitted to maintain a civil action in the first instance—various collateral issues have arisen which the courts have been called upon to decide. In general terms, these issues concern the extent to which a private remedy may be available to an injured purchaser or seller.

A. The "Doorstep Rule"

In the earlier cases brought pursuant to Rule 10b-5, an effort was made by the defendants to limit the scope of the rule to those transactions which had been effected through the media of a national stock exchange or organized over-the-counter markets. Although it will be recalled that Kardon v. National Gypsum Co. recognized an implied civil remedy when the alleged fraudulent transaction was conducted face-to-face, that recognition was purely sub silentio, since the issue was never raised by the defendants.

The argument that Rule 10b-5 was limited to transactions conducted by means of a national exchange or organized over-the-counter market has been predicated on two references in the Exchange Act itself: section 10(b), which delegated authority to the Commission to make such rules as might be necessary "in the public interest," and section 2, which, in setting forth the purposes of the act, pointed to the necessity for regulating transactions conducted by means of an exchange or over-the-counter market. On the other hand, the language of Rule 10b-5 is extremely broad, referring to transactions effected "by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange." Further, the rule's proscriptions apply expressly to "any security" and not merely to listed securities or those traded in the organized over-the-counter market.

In Speed v. Transamerica Corp., the issue was squarely raised by the defendants, who argued that the statement of purposes contained in section 2 left no room for doubt that only "public" sales were protected. Instead of divorcing the specific scope of the rule from the very general purposes alluded to by the defendants, the court merely defined "over-the-counter" in such a way that it would be consistent with the recovery permitted in Kardon:

An over-the-counter transaction is simply one which does not utilize the facilities of a securities exchange, but under the unambiguous provisions of the Act it covers the sale or purchase of a security on a doorstep as well as the trading of a professional securities broker. 76

To strengthen his decision, the trial judge then pointed to the legislative history of the Exchange Act, which militated against the narrow construction urged by the defendants. 77

Another federal district court 78 took the position that although the preamble of the Act referred to securities traded on a national exchange or over-the-counter market, such language could be utilized as an aid to construction only if section 10(b) were ambiguous, which was not the case. In a footnote, the court defined securities traded over-the-counter as "those securities not registered on a national exchange which are traded through a securities broker or with a securities dealer." 79 Thus, even though the court gave to the term "over-the-counter market" a definition far more restrictive than the court had done in Speed, nonetheless the class of transactions within the scope of Rule 10b-5 was held to extend beyond the over-the-counter market as so defined.

A third district court 80 held that Rule 10b-5 was applicable to private transactions, noting that the Rule referred to "any security" and was not limited to securities sold on an exchange or through the organized over-the-counter market. A number of other decisions have recognized the "doorstep rule," either after having expressly considered the issue 81 or tacitly, by permitting the plaintiff, sub silentio, to maintain an action when the transaction was purely face-to-face. 82

A similar question has been whether the conduct prohibited by Rule 10b-5 must itself be effected by means of the mails, an instrumentality of interstate commerce or the facilities of a national securities exchange. The courts have held generally that the fraudulent representations, schemes or transactions need not be carried out by the mails or interstate commerce facilities, as long as those facilities are used "in connection with" the unlawful conduct. 83 This interpretation clearly is consistent

76. Id. at 830.
79. Id. at 148, n.3.
83. E.g., Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952).
with the plain language of the rule. However, a recent decision seems to have required that the mails or facilities of commerce at least be used before the transaction has been consummated, even though the fraudulent conduct itself has ceased prior to the use of the mails or interstate facilities. On the other hand, if the fraudulent activity has ceased but later the mails are used to remit the purchase price of the securities, the rule will have been violated.

B. The Contours of "Fraud" Under Rule 10b-5

A far more crucial question concerns the scope to be given to the loose concept of "fraud" embodied in Rule 10b-5. Although clauses (1) and (3) expressly refer to fraud, no attempt is made to define that term. Moreover, clause (2) seems to impose no requirement of fraud, and simply prohibits untrue statements and omissions to state a material fact.

Most courts that have considered the question agree that "fraud" as used in the first and third clauses of the rule should be given a meaning broader than common law deceit. Thus, for example, although the plaintiff still carries the burden of proving "fraud," it is doubtful that he is required to show scienter on the part of the defendant. On the other hand, reliance by the plaintiff appears to remain necessary.

84. Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962).
85. Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).

Thus, in Texas Continental Life Ins. Co. v. Banker's Bond Co., supra at 23, the court said:

I am of the opinion that it was the intention of the Congress by this legislation to give the purchaser of invalid bonds a right to recover without the necessity of offering proof of deceit and intentional fraud. The statute contemplates a new right of action for the good-faith purchaser to recover from the seller for constructive fraud which grows out of the failure to make a full and complete disclosure.

Compare Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949), in which the court stated that Rule 10b-5 was more limited than common law fraud, because the use of the mails or facilities of interstate commerce must also be alleged and proven.


In Kohler v. Kohler, supra at 823, the court remarked:

Certainly it is reasonable to assume that reliance is inherent in the concept of a breach of duty to disclose material information. If a plaintiff does not rely upon the data he was furnished, how can he say that the undisclosed data was material or that the data he was furnished was "in the light of the circumstances" misleading? Absent proof of reliance, there is no liability.

However, it is in the area of clause (2) that the full potential of Rule 10b-5 seems to lurk. Not only is the word “fraud” absent, but the type of conduct expressly prohibited would not be actionable at the common law. Although liability may be predicated on an untrue statement of a material fact, the rule does not, on its face, require scienter on the part of the defendant or reliance on the part of the plaintiff. Thus, a wholly negligent misrepresentation would seem to be unlawful. Moreover, liability based, as in clause (2), upon an omission to state a material fact was unknown at the common law except in a narrow class of cases.

The second clause of the rule has been instrumental in plugging a gaping loophole in the protection afforded by the common law. According to the majority common law rule, the failure of a corporate insider to disclose material facts prior to his purchase of the corporation’s stock from a shareholder was not actionable. This rule was predicated on the ground that although an insider owed a fiduciary obligation to deal fairly with his corporation, he was under no corresponding duty to the shareholder outside of his duty to refrain from active deception. A minority of courts applied the so-called “special facts” doctrine, which compelled a corporate insider with knowledge of special facts not at the disposal of the ordinary shareholder to disclose such facts prior to purchasing the shareholder’s stock. No doubt it was with a view to the inadequacies of the common law that clause (2) was included by the Commission when it adopted Rule 10b-5.

Although neither section 10(b) nor Rule 10b-5 refer expressly to “insiders,” the cases almost without exception have involved such persons. One case, *Mills v. Sarjem Corp.*, denied recovery under the second clause of the rule on the ground that the defendants were not “insiders” and therefore were under no duty to disclose their reasons for seeking to purchase the plaintiffs’ stock. *Mills* seems to be clearly erroneous. In the first place, the rule itself imposes the duty to disclose; it does not require such a duty as a condition of liability. Secondly, Rule 10b-5

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88. Thus, in Blabon v. Hay, 269 Mass. 401, 407, 169 N.E. 268, 271 (1929), the court stated: “The fact that the defendants were directors created no fiduciary relation between them and the plaintiff in the matter of the sale of his stock.”

For a list of authorities supporting the majority common law view, see Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).

89. The doctrine owes its origin to the following language in *Strong v. Repide*, 213 U.S. 419, 431 (1909);

If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to the shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, *yet there are cases where, by reason of the special facts, such duty exists*. (Emphasis added.)


expressly prohibits the designated conduct by "any person," and not when performed by "insiders" alone. Third, when it was intended that liability be restricted to insiders, that intention was carried out by specific provisions to that effect, as in section 16(b) of the Exchange Act. Moreover, the decision in Mills is self-contradictory, for it refers to an insider's duty to disclose which, except under the minority "special facts" doctrine, was imposed for the first time by the rule itself. Perhaps in the back of the court's mind was the belief that the second clause of Rule 10b-5 was simply the codification of the "special facts" doctrine, which admittedly applied only in the case of the corporate insider. However, in view of the unfettered language of clause (2), and of the entire rule for that matter, such a theory is wholly untenable.

The case which has been most significant in marking the contours of the prohibitory language of Rule 10b-5 is the Commission's decision in Cady, Roberts & Co. There, a broker received information from the directors of the Curtis Wright Company that the board had met and decided to reduce the dividend rate on the company's stock. Although the information had been relayed for public distribution, the defendant broker sold a number of shares for discretionary accounts and sold short other shares, all prior to the time when the new dividend policy became a matter of public knowledge. Although the defendant knew at the time of the transactions that the information was not yet public, it failed to disclose to the purchasers the company's decision to reduce the dividend rate. The Commission brought an action to suspend the broker's trading privileges pursuant to section 17(a) of the Securities Act and Rule 10b-5. These provisions, said the Commission, were "broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." The Commission went on to add that the anti-fraud provisions "are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass

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91. Thus, in Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951), the court unequivocally declared:

The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction.

Defendant's contention that only express misrepresentations or half-truths are unlawful fails to look at the fact that an implied misrepresentation is just as fraudulent as an express one and constitutes an untrue statement of a material fact within the meaning of the governing rule.


93. Id. at p. 81,015.
the infinite variety of devices by which undue advantage may be taken of investors and others.\textsuperscript{94}

Finally, the Commission declared the relationship between the three clauses of section 17(a) and Rule 10b-5 to be mutually supporting rather than mutually exclusive. Thus, a breach of the duty to disclose might result in the violation of all three parts of the rule and of section 17(a).\textsuperscript{95} In this connection, it was determined that the defendant's failure to disclose the dividend information constituted a practice which operated as a fraud or deceit upon the purchasers, in violation of the third clause.\textsuperscript{96} Although the Commission found it unnecessary, therefore, to decide the scope of the other two clauses, it is inconceivable that future decisions would undertake to impose a more narrow construction on those clauses, especially in view of the fact that \textit{Cady, Roberts & Co.} incorporates into the concept of fraud itself, at least in clause (3), a duty of disclosure which was virtually nonexistent at the common law.

C. Privity and Reliance

Next to the question of whether Rule 10b-5 furnishes an unrestricted private right of action to defrauded buyers and sellers of securities, the most significant issue before the courts today concerns the question of whether privity of contract between the plaintiff and defendant is necessary. It will be recalled that strict privity between the parties was not required in the common law action of deceit, and that section 11 of the Securities Act imposes no such prerequisite. Only section 12(2), pursuant to which the defendant is held "liable to the person purchasing such security from him," seems to be delimited by the requirement of privity.

The first suggestion that the court-implied right of action under section 10(b) and Rule 10b-5 might be circumscribed by a privity limitation arose in a 1951 decision of the Federal District Court for the Southern District of New York. In \textit{Joseph v. Farnsworth Radio & Television Corp.},\textsuperscript{97} the directors of the defendant corporation published false statements concerning the financial condition of the company in order to induce others to purchase shares of stock owned by them. The defendants sold their shares directly to unknown third persons; some twelve days after the last share was sold by any of the defendants, the plaintiffs purchased

\textsuperscript{94} \textit{Id.} at p. 81,016.

\textsuperscript{95} The duty of disclosure seems to have been broadened in the recent case of \textit{List v. Fashion Park, Inc.}, CCH \textit{Fed. Sec. L. Rep.} \# 91,467 (S.D.N.Y. Jan. 4, 1965). There the court held that even when there was a total nondisclosure, as where the parties had never communicated with each other, the Exchange Act would still be violated. To hold contrary, the court added, would automatically exempt many impersonal transactions contrary to the intent of Congress, as expressed by \textsection 2 of the Act.

\textsuperscript{96} \textit{But see Hafner v. Forest Laboratories, Inc.}, CCH \textit{Fed. Sec. L. Rep.} \# 91,443 (S.D.N.Y. Oct. 27, 1964), which stated that an impending stock dividend was not such a material fact as would make nondisclosure actionable under Rule 10b-5.

\textsuperscript{97} 99 F. Supp. 701 (S.D.N.Y. 1951).
a number of shares through a national exchange. When the true facts
were known, the price of the stock fell and the plaintiffs sold their shares
at a loss. In denying the right of the plaintiffs to maintain an action, the
trial judge declared:

A semblance of privity between the vendor and purchaser of
the security in connection with which the improper act, practice
or course of business was invoked seems to be requisite and it
is entirely lacking here. 98

Precisely what the court had in mind when it referred to a "semblance of
privity" is not entirely clear. In granting the plaintiffs leave to amend their
complaint, Judge Sugarman suggested that an additional allegation of
reliance, "coupled with the possibility that later sales by the individual
defendants may form the basis of privity with these plaintiffs dictates
that a fair opportunity to explore such prospects should be accorded be-
fore the plaintiffs' claims are conclusively snuffed out." 99 This statement
indicates that if strict privity is not required, then at least some degree of
reliance upon the false statements will be required. For reasons not
explained—perhaps because the plaintiffs were unable to allege that they
had relied on the untrue financial statements—the plaintiffs chose to
appeal rather than to amend their complaint as suggested by the trial
court. On appeal, the Second Circuit affirmed per curiam. 100 Of signifi-
cance, however, is Judge Frank's dissent, in which he indicated that
reliance may constitute a satisfactory substitute for, or at least a "sem-
blance of," privity. He distinguished Birnbaum v. Newport Steel Corp., 101
in which the complaint was dismissed because the plaintiff was neither a
purchaser nor seller, noting that Birnbaum could not be construed so as
to demand privity between the plaintiff and the defendant. In this in-
stance, Judge Frank was undoubtedly correct, for although it would seem
that the purpose of Rule 10b-5 demands that the plaintiff be at least a
defrauded purchaser or seller, it does not compel a finding that the parties
must occupy a relationship of privity of contract. 102

It is interesting to note that neither the lower court nor the Second
Circuit made mention of Fischman v. Raytheon Mfg. Co., 103 where, it will
be recalled, the plaintiffs had purchased common stock on the open market
in reliance upon false statements in a registration statement covering the
defendant's preferred stock. Unless the silence of the court in Farnsworth

98. Id. at 706.
99. Id. at 706-707.
101. 193 F.2d 461 (2d Cir. 1952).
102. But see Donovan, Inc. v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955), where the
court denied recovery in the absence of privity, citing Birnbaum as authority.
For an excellent criticism of the lower court decision in Farnsworth, see Comment, 4
STAN. L. REV. 308 (1952), from which Judge Frank quoted at length in his dissent in the
Farnsworth appeal.
103. 188 F.2d 783 (2d Cir. 1951).
is taken to express its satisfaction that the element of reliance present in *Fischman* served as a "semblance of privity," there may be reason to doubt the validity, in the Second Circuit, of the earlier decision.

Notwithstanding the *Farnsworth* case, the privity issue is still far from settled. In all but a few cases, strict privity of contract was in fact present and, consequently, the issue was not raised. In other cases, although the facts seem to indicate that the plaintiff and defendant did not deal directly with each other, the absence of privity was not determinative because there existed another ground for denying the plaintiff's claim. Ironically, although the most recent decision under Rule 10b-5 permitted recovery even though from the facts it is clear that privity was lacking, the *Farnsworth* case was cited favorably.

No court has faced the privity issue so squarely as did the Kentucky district court in *Texas Continental Life Ins. Co. v. Banker's Bond Co.* There, the plaintiff purchased shares of stock after the defendant had sold to intervening parties in the open market. In meeting head-on the defendant's argument that the plaintiff was barred by the absence of privity, the court stated:

The court is of the opinion that such a fact is not material under the statute. Rule X-10b-5 admits of no such loophole but on the contrary speaks of the duties and obligations of the seller. It is common knowledge that there is frequently lack of privity of contract between a bonding house handling an issue of bonds and the ultimate investor. One of the purposes of the legislation was to prevent an imposition upon the public by individuals and corporations whose business was dealing in securities and who had training, knowledge and experience in the practical processes of a bond issue and the property and potential back of it.

The remaining cases which have dealt with the privity issue reside between the two poles that are the *Farnsworth* and *Texas Continental* decisions. Thus, in *Buchholtz v. Renard*, the same court that required a semblance of privity in *Farnsworth* relented to some extent when, in a situation involving multiple plaintiffs and defendants, it held it unnecessary for the plaintiffs to allege specifically which defendants had sold to

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105. Thus, for example, in Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963), although the court noted that no "semblance of privity" was present, the observation was interjected as an afterthought. Earlier, the court had noted that the plaintiff purchased his stock prior to the defendant's alleged misrepresentation, thereby destroying the possibility of reliance as a substitute for privity.


108. *Id.* at 24.

which plaintiffs. *Farnsworth* was distinguished on the ground that there the defendants had not sold directly to any of the plaintiffs but, rather, to third persons. Clearly, the distinction is a valid one, and the defendants' objection that privity was absent seems to be stretching an already tenuous argument to the breaking point. However, the court was not content to rest with that observation: *Farnsworth* was distinguished still further, namely, on the ground that there the defendants had sold their last share almost two weeks before the plaintiffs had purchased their first share. Within this kernal of dictum lie a couple of interesting possibilities. First, assuming that the plaintiffs in a given case are unable to allege that they had relied on the defendants' false statements (as they were apparently unable to do in *Farnsworth*), will "privity" or some semblance thereof nevertheless be found to exist as long as the plaintiffs can demonstrate that they were buying and the defendants were selling *at the same time*, even though not to each other? Second, assuming, on the other hand, that the defendants had sold their last share prior to the first purchase by the plaintiffs, will "privity" be found to exist if the intervening period is not too great? *Buchholtz* indicates that a period of twelve days, the time involved in *Farnsworth*, is too long, but will a shorter period suffice? These are interesting questions which the dictum in *Buchholtz* did not consider—if, indeed, the court even realized that such questions were imbedded in its seemingly innocuous statement.

Most of the courts that have been faced with the privity issue have been content to take the easy way out by accepting reliance as a satisfactory substitute for strict privity of contract, consistent with the dictum in *Farnsworth*.$^{110}$ One decision, however, seems to have come to grips with the question in a rather novel manner. In *Cochran v. Channing*,$^{111}$ although the parties were not in privity it is clear that the plaintiff would not have sold his stock had the defendants disclosed certain material information concerning the company's reduction of its dividend rate. In short, reliance was present even though strict privity of contract was not. Citing a previous decision in which privity was raised in connection with a different statute,$^{112}$ privity was held not to be a condition precedent to the plaintiff's right to maintain the action but, rather, was viewed as simply one element of proof to be considered along with other factors. Ironically (in view of the broadly remedial interpretation it has given to the rule), the Commission, in dicta, has seemed to favor the existence of privity as a condition of civil liability under Rule 10b-5, although the absence of privity will not defeat the availability of administrative sanctions under the rule.$^{113}$


The preoccupation of the courts with the privity question seems to be unfortunate. Far from referring to privity in affirmative terms, both section 10(b) and Rule 10b-5 impose liability on "any person . . . in connection with the purchase or sale of any security." Moreover, both section 10(b) and the rule are expressly applicable to exchange transactions which, by their very nature, often place the purchaser or seller of securities in a position several steps removed from the origin of the fraudulent representations on which he relies. The same conclusion would seem to follow from the fact that the specified activity is unlawful whether "directly or indirectly" conducted.

It is difficult to believe that Congress, especially in view of the legislative history of section 10(b),114 intended by using such comprehensive language to impose a requirement of privity between the parties. Moreover, it was the purpose of the Exchange Act to expand the common law liability for fraud in securities transactions. When it is remembered that even at the common law privity was not a necessary element in an action for deceit, it seems illogical to require it under the statute, which was intended to provide a more liberal remedy than under the common law. At the same time, however, it does not seem unreasonable to demand some sort of reliance on the part of the plaintiff.115

D. The Texas Gulf Sulphur Litigation

At the present time, a further test of the elastic qualities of Rule 10b-5 appears to be in the making. Recently, the Commission brought civil proceedings against thirteen officers, directors and employees of the Texas Gulf Sulphur Company, accusing them of making use of inside information concerning the company's Canadian ore strike to trade in Texas Gulf stock before the news of the discovery was made public. In its complaint for injunctive relief, the Commission has charged that the company and the individuals named as defendants "have engaged, are engaged, and are about to engage, in acts and practices which constitute and will constitute violations of section 10(b) of the Securities Exchange Act of 1934 . . . and of Rule 10b-5 . . . ."116 In addition, a number of private suits have already been initiated by former shareholders who sold their stock in the corporation in ignorance of the company's ore dis-

Experience with State laws designed to prevent the exploitation of the investor by supervision of the sale of securities has demonstrated the inadequacy of criminal penalties as the sole sanction. Customers are ordinarily reluctant to resort to criminal proceedings and in the absence of complaints by them, the discovery of violations is often impossible. Furthermore, if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. (Emphasis added.)
115. See 3 Loss, SECURiTIES REGULATION 1766 (2d ed. 1961); Comment, 4 STAN. L. REV. 308 (1952).
covery, and some of these actions have been consolidated on the ground that they involve substantially the same issues of law and fact.\textsuperscript{117}

The facts alleged in the pending litigation present an almost classic case of Rule 10b-5 violations.\textsuperscript{118} On or about November 8, 1963, the company commenced exploratory test drilling in the vicinity of Timmins, Ontario, and by November 12, an initial hole was completed which showed the presence of high grade ores. According to the Securities and Exchange Commission, immediately after visual inspection of the drill core by the company's geologist, steps were taken to disguise the discovery. The drill rig was moved to another site, trees were planted in the test hole and a worthless core was left nearby. On the other hand, officials of the company urge that the concealment of the rich strike was effectuated for the purpose of enabling the company to purchase additional land surrounding the small tract owned by the company where the ore was discovered.

Notwithstanding the tight security precautions, which apparently endured long enough to enable the company to purchase the desired land in the vicinity, news began to filter out concerning the ore discovery and widespread rumors began to be circulated, followed by frantic speculation in mining shares on the Toronto Stock Exchange. In an effort to quell the rumors and allegedly for the purpose of complying with the New York Stock Exchange requirement of prompt clarification in such situations, on April 12, 1964, the company issued a press release which labeled the rumors "premature and probably misleading." On April 15, the analyses of other test drillings were completed, which showed that the optimism connected with the initial findings was well-founded. The company called a press conference for the following morning, at which time the news media were told that the company had made a "major discovery" which preliminary data indicated consisted of 25 million tons of ore.\textsuperscript{119}

The Commission has charged that between November 12, 1963, shortly after the strike was discovered and its potential appreciated by the company, and April 16, 1964, when the news was made public, the thirteen individual defendants purchased in the open market an aggregate of 9,100 Texas Gulf shares, bought "calls" on 5,200 shares and were voted options to purchase 31,200 shares at a price of approximately 24 dollars per share. In this connection, it is interesting to note that on

\textsuperscript{117} Wall Street Journal, April 21, 1965, p. 4, col. 3.
\textsuperscript{118} This statement of the facts has been compiled from the Commission's allegations in its Complaint for Injunction, supra note 114, and from news articles in the Wall Street Journal appearing on the following dates: April 20, 1965, p. 3, col. 1; April 21, 1965, p. 4, col. 3; April 23, 1965, p. 3, col. 1.
\textsuperscript{119} Later estimates predicated on more complete information placed the probable body of ore in the vicinity of 60 million tons of high grade copper, zinc, silver, and lead, worth an estimated $2 billion. Life Magazine, August 6, 1965, p. 29.
November 11, 1963, the stock was selling for about 17 dollars per share, while on April 16, 1964, the price had risen to 37 dollars and by the end of the month was up to 58 dollars per share. On April 19, 1965— the date the SEC filed its suit—Texas Gulf Sulphur reached its highest level, closing at 71 dollars per share.\(^{120}\)

Although the litigation is still only in the preliminary stages, a few observations are relevant and some interesting issues may be raised. First, it seems clear that section 10(b) encompasses the type of violations allegedly committed by the defendants. Moreover, the language in *Cady, Roberts & Co.*\(^{121}\) to the effect that the three clauses in Rule 10b-5 are mutually supporting seems to be justified by the facts involved here. It is clear that, at the time the stock was purchased by the defendants, information concerning the ore discovery was not communicated to the persons who sold their stock, thereby violating clause (2) of the rule. The press release of April 12, 1964, to the extent that it was false or misleading, would lie well within the proscription of the second clause as well. Finally, the designed concealment of the ore discovery, the elaborate steps taken to camouflage the strike, along with the continuous purchase of shares by the defendants during that period is easily susceptible of characterization as a device, scheme or artifice to defraud, or, in the alternative, as an action or practice which would operate as a fraud or deceit in violation of the first and third clauses of the rule.

Another interesting issue concerns the need for privity between the individual defendants and the injured sellers. It is clear from the Commission's opinion in *Cady, Roberts & Co.* that privity should be immaterial in an action brought by the Commission.\(^{122}\) However, private litigation is also pending which may be thwarted by the fact that most, if not all, of the shares sold were purchased by the defendants on the open market. At this time, the degree of reliance on the part of the selling shareholders is not known, but as suggested earlier,\(^ {123}\) reliance would appear to be an acceptable substitute for privity between the parties.

It should be noted that although Rule 10b-5 does not prescribe any specific remedies for violation of its provisions, the civil remedies which have been granted for its violation include rescission and restitution, damages and injunctive relief.\(^ {124}\) Although the Commission has not yet released a full outline of the liability that the company may face, its com-

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120. Thereafter, news of the SEC's action caused Texas Gulf stock to lose ground, reaching its low of 49 on June 28. However, by January 19, 1966—nine months after the Commission filed its suit—the stock closed at 90\(\frac{3}{8}\) reflecting investor confidence in both the company and those at its helm.


122. *Id.* at ¶ 81,019: "The absence of a remedy by the private litigant because of lack of privity does not absolve an insider from responsibility for fraudulent conduct."

123. See section V(C) of this paper's text supra.

124. See generally, 3 Loss, SECURITIES REGULATION Ch. 11C (2d ed. 1961).
plaint has asked the court to do the following: (1) permanently enjoin the defendants from making further use of inside information in buying and selling Texas Gulf stock; (2) order ten of the defendants to offer rescission to the sellers; (3) order one of the defendants not only to make restitution to those who sold their stock to him, but also to persons who sold to friends of the defendant who purchased pursuant to his recommendations; (4) order five of the defendants to cancel existing options to purchase shares and to return all profits or shares obtained from the exercise of stock options already granted; (5) order the company to refrain from making further untrue statements concerning its activities; and (6) order such other general relief as the court may deem appropriate.125

It is apparent that if the court grants the relief requested, the power of the Commission will be significantly enlarged; indeed, the executive vice-president of Texas Gulf Sulphur has criticized the Commission for attempting to make a test case that will enable it to strengthen its policing powers and to prompt legislation which would effectively forbid an insider from purchasing stock in his company.126 Whatever may be the motives of the Commission, it seems clear that the enforcement powers of the Commission sought to be exercised go far beyond anything known at the present time. For one thing, although a defrauded investor is entitled to demand restitution from a purchaser under Rule 10b-5, the power of the Commission in an administrative proceeding to order restitution is open to serious doubt. And when, as here, the Commission as plaintiff in a civil action before the courts prays that restitution be ordered in favor of persons who are not even parties to the litigation, the remedy strikes one as being even more unorthodox. Indeed, it is debatable whether a court of equity is vested with power in such a case to compel the defendants to make restitution to persons who not only have not been made parties plaintiff in the litigation but, in addition, who have not been identified by the Commission.127 Even if such a remedy were properly within the power of a court of equity to grant, how will the individual recipients of restitution be ascertained? In view of these procedural difficulties, it would not be surprising if the court were to find that the relief requested by the Commission is better suited to the various private actions currently pending before the courts.

125. Complaint for Injunction, supra note 114, at 33-35.
127. In United States v. Parkinson, 240 F.2d 918 (9th Cir. 1956), a similar question was presented when the Food and Drug Administration sought to enjoin violations of § 301(a) of the Food, Drug and Cosmetic Act. As additional relief, the FDA sought to compel restitution to persons who had expended money on a sexual rejuvenant sold by the defendants in violation of the Act. The court held that the statute in question did not confer upon the courts jurisdiction to grant the relief prayed for and that the so-called "general powers of equity" could not be relied on to justify the creation of remedies not authorized by the statute.
On the other hand, it may be argued that the relief sought by the Commission, though unorthodox and difficult of enforcement, comports with the fundamental policy of protecting the investor and the public interest—a policy which is spelled out by the Exchange Act in general and by section 10(b) in particular. It is submitted, however, that although this policy may be relied on to justify the pursuit of remedies within the framework of jurisdiction patently established by Congress, it does not follow that the extent of rights conferred by Congress can be extended in the name only of a broad statement of policy with nothing more to justify it.

VI. Conclusion

The perplexing difficulties of interpretation which have seemed to follow Rule 10b-5 at virtually every turn may be blamed, for the most part, on the imprecision in wording of the rule itself; especially when it is viewed in the light of the specific language of the express liability provisions of the two acts. It is submitted that this state of affairs is attributable more to the fact that the Commission failed to appreciate the rule's potential than to the fact that in adopting the rule it attempted to cure too much with too little. It is true that section 17(a) of the Securities Act is no more commendable by way of precision; however, so far it has been Rule 10b-5 and not section 17(a) which has been utilized to extend the boundaries of civil liability. Indeed, the irony of Rule 10b-5 lies in the fact that the arsenal of private remedies has been expanded so greatly by only a few words, and by words which, at that, do not even refer to civil relief. Moreover, it should not be forgotten that this expansion owes its existence to an administrative rule rather than to an act of Congress. Despite the fact that the constitutionality of Rule 10b-5 has been upheld as a valid exercise by the Commission of the rule-making authority delegated to it by Congress, it is still questionable whether Congress intended section 10(b), as implemented by the rule, to be employed as a means of nullifying many of its own express enactments.

If, as has been suggested, the Supreme Court is disposed to uphold the judicial extension of liability under Rule 10b-5, in the absence of a comprehensive reappraisal by the Congress the anomalies associated with the rule seem destined to persist. It is entirely within the realm of possibility that, given a liberal construction, Rule 10b-5 would be broad enough to encompass every type of violation presently cognizable under the express provisions of the two acts, while at the same time it would avoid the built-in restrictions and limitations contained in those provisions. Thus, for example, by the simple process of "characterization," a false or misleading registration statement, actionable under section 11

of the Securities Act, might be held to constitute a "scheme, or artifice to defraud" or an "untrue statement of a material fact" within Rule 10b-5. Similarly, an unlawful proxy solicitation violative of section 14 of the Exchange Act, might constitute a practice which would operate as a fraud or deceit under the rule.\footnote{130}

As plaintiffs' attorneys become increasingly more inventive in finding new uses of Rule 10b-5, the burden imposed upon the courts to preserve the federal acts as an integrated body of securities regulation will become correspondingly more weighty. The fact that Congress was content to let the Commission provide remedies for problems which the latter was better able to foresee does not justify the conclusion that Congress intended that its express enactments be rendered superfluous. The language of Rule 10b-5, no matter how unfettered it may appear on its face, nevertheless must be interpreted with a view to the probable intent of Congress in delegating authority to the Commission, namely, to mend the loopholes in investor protection and not to reweave an entirely new fabric.

\footnote{130. \textit{But see} Borak v. J. I. Case Co., 317 F.2d 838, 847 (7th Cir. 1963), wherein the court refused to consider whether misleading proxy material might, under any circumstances, constitute a manipulative and deceptive device within the prohibition of \$ 10(b) and Rule 10b-5, remarking that "only sheer speculation can bring the provisions of 10(b) into play." \textit{Borak} was cited favorably in Barnett v. Anaconda Co., \textit{CCH Fed. Sec. L. Rep.} \$ 91,502 (S.D.N.Y. Feb. 17, 1965). Compare Dembitzer v. First Republic Corp., \textit{CCH Fed. Sec. L. Rep.} \$ 91,445 (S.D.N.Y. Oct. 23, 1964), which suggested that a false prospectus might constitute a device to defraud within the meaning of Rule 10b-5.}