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Settling the Scienter Split:Why Scienter Should Not Be Required forSEC Enforcement of Rule 13b2-2 Violations

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Settling the Scienter Split: Why Scienter Should Not Be Required for SEC Enforcement of Rule 13b2-2 Violations

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I. INTRODUCTION

"When misinformation causes loss, it is small comfort to the investor to know that he has been bilked by negligent mistake rather than by fraudulent design, particularly when recovery of his loss has been foreclosed by this Court's decisions."[1] Courts have been analyzing various Securities and Exchange Commission ("SEC") rules since the SEC was established, to determine on a rule-by-rule basis, if scienter[2] is an element that the Commission must prove in order to prevail in civil enforcement actions.[3]

In early 2008, executives of Thornburg Mortgage (Thornburg), a publicly traded company, disseminated information to auditors to prepare the company's 2007 form 10-K.[4] Thornburg had a tough year in 2007; the weakening real estate market decreased the company's investment values, resulting in margin calls on its investment loans.[5] Despite this, the executives prepared a letter to Thornburg's outside auditor overstating the financial condition of the company.[6] Based on this information, the auditors agreed that the losses were temporary and did not need to be disclosed to shareholders.[7] Over the course of the year, asset values

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[1] Aaron v. SEC, 446 U.S. 680, 716 (1980) (Blackmun, J., dissenting). In a suit brought by the SEC for injunctive relief for a violation of Rule 17(a)(2) or 17(a)(3), the Court held that the SEC was required to establish scienter. Justice Blackmun dissented based on statutory interpretation and congressional intent.

[2] BLACK'S LAW DICTIONARY 1373 (9th ed. 2009) (defining scienter as "a degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, especially as a ground for civil damages or criminal punishment").

[3] *See generally* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 188 (1976); Aaron v. SEC, 446 U.S. 680 (1980).

[4] SEC v. Goldstone, 952 F. Supp. 2d 1060, 1077 (2013).

[5] *See generally* Patrick Fitzgerald, *Judge Says SEC Can Proceed with Thornburg Mortgage Fraud Suit*, WALL ST. J. (July 9, 2013, 2:03 PM), http://online.wsj.com/news/articles/SB10001424127887323368704578595811853715032.

[6] *Goldstone*, 952 F. Supp. 2d at 1086.

[7] *Id.* at 1093.

continued falling, and in May of 2009, Thornburg filed for Chapter 11 bankruptcy protection, resulting in a total loss for investors holding common shares.[8]

The SEC brought multiple claims against the executives, including one under SEC Rule 13b2-2.[9] The Commission alleged that the executives: (1) failed to disclose that the company was struggling to meet margin calls; (2) took temporary measures to ward off margin calls; and (3) would be forced to sell investments at a loss due to the impending hedge fund collapse.[10]

The executives mounted a defense based on a lack of scienter.[11] They argued that the SEC failed to prove that they disregarded obvious "risks of misleading investors," failed to allege facts demonstrating the executives "believed the statements in the 10-K were false or misleading at the time they were made," and failed to prove that they "prepared the 10-K with any intent to defraud investors."[12] Interoffice e-mails document the executives' awareness that the information provided to the accountants was misleading.[13]

This kind of communication by Thornburg's executives is problematic under SEC regulations. SEC Rule 13b2-2 was enacted to prevent the communication of misinformation to accountants in connection with audits or SEC filings.[14] By signing the letter to the auditors, the executives functionally ratified the information contained in the letter. Whether or not the SEC could prove an *intent* to mislead the accountants, the executives became responsible when they signed the letter. By eliminating negligence as a defense for violations of Rule 13b2-2, executives are forced to make themselves aware of the content they are certifying and to ensure that it is correct. This is important to protect investors and to hold executives accountable for both negligent and intentionally fraudulent actions.

Rule 13b2-2 provides that "no director or officer shall, directly or indirectly . . . [m]ake or cause to be made a materially false or misleading statement to an accountant . . . ."[15] The Rule extends to information provided to accountants and auditors who produce the filings which public companies are required to file with the SEC.[16] Investors directly and

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8 *Id.*

9 *Id.* at 1088.

10 *Id.* at 1091-92.

11 *Id.* at 1103.

12 *Id.* at 1094.

13 *Id.* at 1086.

14 *See generally* Representations and Conduct in Connection with the Preparation of Required Reports and Documents, 17 C.F.R. § 240.13b2-2 (2015).

15 17 C.F.R. § 240.13b2-2(a) (2015).

16 17 C.F.R. § 240.13b2-2(b)(1) (2015).

indirectly rely on the integrity of the data contained in these filings when purchasing securities.[17] Direct reliance occurs when investors review company financial reports and releases to make investment decisions.[18] Indirect reliance is assumed based on the efficient capital market theory.[19]

The federal circuit courts of appeals are currently split on the issue of whether the SEC should be required to prove scienter in Rule 13b2-2 civil enforcement actions.[20] This article will demonstrate that, because the SEC and the investing public rely on the data provided to accountants and auditors, the SEC should not be required to prove the element of scienter when enforcing Rule 13b2-2 in civil actions. Holding directors and officers to a negligence standard will discourage carelessness and ensure that accountants receive accurate information, which is in the best interests of the investing public.[21]

To set the stage, Section I(A) will begin by explaining why the SEC was created. An analysis of the legislative intent behind the enabling statute for Rule 13b2-2, and a discussion of the SEC's purpose for drafting Rule 13b2-2 follow. The legislature and the SEC's intent are essential to the argument against a scienter requirement. The article continues with an in-depth discussion of the Ninth and Second Circuit cases representing the two leading interpretations of Rule 13b2-2 with respect to scienter in Sections II and III respectively. Section IV examines recent laws passed by Congress to show that the concerns that originally gave rise to Rule 13b2-2 still exist. Section IV also highlights recent legislation in light of the economic crises this country has experienced and the legislation created in its wake. Deference to agency interpretations, including the *Chevron* and *Skidmore* doctrines, provide context for the legal basis concerning deference to the SEC interpretation of its own rules. Finally, the Section V summarizes the analysis, concluding that the SEC should not be required to prove scienter when enforcing Rule 13b2-2.

A. Creation of the SEC

Beginning in the late 1920s and lasting approximately ten years, the Great Depression was a severe economic downturn causing rampant

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17 Basic Inc. v. Levinson, 108 S. Ct. 978, 989 (1988) (citing Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d. Cir. 1986)).

18 *See id.* at 980.

19 *Id.* at 991 n.24 (explaining that the efficient capital market theory means that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices").

20 *See* SEC v. Goldstone, 952 F. Supp. 2d 1060, 1212 (2013) (discussing the split between the Second and Ninth Circuits).

21 *See* Byron F. Egan, *Major Themes of the Sarbanes-Oxley Act*, 42 TEX. J. BUS. L. 333, 430-33 (2008).

unemployment and stock market declines.[22] While the reasons for the depression are debated, varied, and mostly beyond the scope of this article, manipulation of the securities markets was a contributing factor.[23] In the wake of the Great Depression, securities and banking legislation was enacted to increase transparency and prevent the scenarios that contributed to the economic decline from recurring.[24] The Securities Exchange Act of 1934 was passed during this period and was the legislation that created the SEC.[25]

The SEC is an independent administrative agency[26] of the Executive Branch of the United States Government.[27] The Commission's original purpose was to restore investor confidence by ensuring that the companies, brokers, and exchanges disseminated honest information, putting investors' interests before their own.[28] The current mission statement of the Commission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[29] The SEC uses a number of key functions to carry out its mission.[30] The Commission interprets existing federal securities laws and creates new rules to further its goals.[31] The Commission provides oversight of broker-dealers, ratings agencies, and self-regulatory organizations ("SRO") and enforces securities laws and rules.[32]

B. SEC Rulemaking

The SEC creates rules within the Administrative Procedure Act ("APA") guidelines.[33] Rules are usually created at the direction of an enabling act[34] or one of the rulemaking divisions within the Commission:

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22 Joy Sabino Mullane, *Perfect Storms: Congressional Regulation of Executive Compensation*, 57 VILL. L. REV. 589, 594 (2012).

23 Norman S. Poser, *Stock Market Manipulation and Corporate Control Transactions*, 40 U. MIAMI L. REV. 671, 690 (1986).

24 Mullane, *supra* note 22, at 600-01.

25 *Id.* at 601.

26 Daniel J. Gifford, *Adjudication in Independent Tribunals: The Role of an Alternative Agency Structure*, 66 NOTRE DAME L. REV. 965, 969 (1991).

27 *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N (Mar. 14, 2014), http://www.sec.gov/about/whatwedo.shtml [hereinafter U.S. SEC. & EXCH. COMM'N].

28 *See id.*

29 *See id.*

30 *See id.*

31 *See id.*

32 *See id.*

33 *See* Renee M. Jones, *Legitimacy and Corporate Law: The Case for Regulatory Redundancy*, 86 WASH. U. L. REV. 1273, 1311 (2009).

34 *See id.* at 1312.

the Market Regulation, Corporate Finance, or Investment Management divisions.[35] As in other administrative contexts, the rulemaking process consists of three general steps.[36] First, the Commission may begin with a concept release, outlining a problem that needs to be solved and seeking proposed solutions from the public to remedy the problem.[37] Next, the APA requires the Commission to publish a proposed rule in the Federal Register.[38] Interested parties are given an opportunity to voice support for or concerns about the proposed rule and to participate in the rulemaking process.[39] The final rule, including any changes proposed and accepted during the notice and comment period, is then published in the Federal Register.[40]

C. SEC Investigation and Enforcement

Many types of conduct can trigger an SEC investigation of potential SEC rule violations.[41] The SEC engages in market surveillance, receives tips and complaints from investors, and coordinates with other governmental entities to uncover possible rule violations and initiate investigations.[42] A thorough investigation is conducted using methods such as reviewing financial records and interviewing associated parties.[43] After a case is developed, it is presented to the Commissioners to decide what, if any, remedy should be sought.[44]

The SEC may pursue various remedies to thwart ongoing violations of law or seek justice for violations that have occurred.[45] The SEC is limited to civil enforcement of the federal securities laws.[46] A panoply of remedial mechanisms exist: a cease and desist order to stop ongoing activities, an injunction to prevent future violations, monetary penalties (fines) to punish and discourage future violations, and disgorgement to prevent unjust enrichment from ill-gotten gains.[47] Criminal enforcement may be sought

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35 David S. Ruder, *Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case*, 26 PACE L. REV. 39, 52 (2005).

36 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 27.

37 *See id.*

38 5 U.S.C. § 553 (2015).

39 *Id.*

40 *Id.*

41 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 27.

42 *Id.*

43 *See id.*

44 *See id.*

45 Griffin Finan et al., *Securities Fraud*, 48 AM. CRIM. L. REV. 1129, 1183 (2011).

46 *Id.* at 1183.

47 Rebecca Gross et al., *Securities Fraud*, 49 AM. CRIM. L. REV. 1213, 1266-72 (2012) (discussing remedies that the SEC can seek).

only through another agency like the Department of Justice ("DOJ"), with or without SEC involvement.[48]

D. The History of Rule 13b2-2

The focus here is on a specific SEC Rule: 13b2-2. Concern for the accuracy of financial statements was addressed in section 11 of the original Securities Exchange Act of 1934.[49] Section 11 allowed for investors to sue directors and officers for rescission or damages for losses resulting from material misinformation or omissions.[50] Showing a reasonable belief in the information when it was communicated allows directors and officers to avoid liability.[51] The same is true today.[52]

In the 1970s, a Watergate Special Prosecutor's investigation uncovered hundreds of illegal bribes by domestic corporations to foreign political officials.[53] The SEC suggested a new set of rules to supplement the 1934 Act to, among other things, "prohibit the making of false, misleading or incomplete statements to an accountant in connections with any examination or audit" used to cover up such bribes.[54] As a result, Congress adopted the Foreign Corrupt Practices Act in 1977, and created section 13(b)(2) of the 1934 Act.

Born from this new legislation, Rule 13b2-2 was intended to "encourage careful and accurate communications between auditors and issuers from whom they request information during the audit process, deter the making of false, misleading or incomplete statements to accountants, and thereby enhance the integrity of the financial disclosure system."[55] During the notice and comment period for the original Rule, commenters expressed concern for the lack of a scienter requirement.[56] The Commission responded that a scienter requirement would be inconsistent with section 13(b)(2), which indicated no congressional intent to impose a scienter requirement.[57]

The enabling statute for the modern Rule 13b2-2 is section 303(a) of

48 *Id.* at 1275.

49 John Hanna, *The Securities and Exchange Act of 1934*, 23 CALIF. L. REV. 1, 6 (1934).

50 *Id.*

51 *Id.*

52 *Id.*

53 Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices, Exchange Act Release No. 15,570, 16 SEC Docket 1143 (Feb. 15, 1979).

54 *Id.* at 3.

55 *Id.* at 10.

56 *Id.* at 12.

57 *Id.* at 10.

the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[58] It was created in the wake of the stock market decline and accounting scandals which marked the first two years of the new millennium.[59] A number of well-known publicly traded companies filed for bankruptcy protection during this period, including Enron, WorldCom, Global Crossing, Adelphia Communications, and Tyco International.[60] These corporations perpetrated accounting fraud in cooperation with large accounting firms, costing investors billions of dollars and eroding the public confidence in the securities markets.[61] Congress enacted Sarbanes-Oxley in response to the accounting fraud, market decline, and drop in investor confidence to prevent a repeat of history.[62]

In furtherance of Sarbanes-Oxley, the SEC initiated rulemaking to create Rule 13b2-2, intended to replace Rule 13B-2.[63] Rule 13b2-2 was proposed on October 18, 2002.[64] After a notice and comment period, the Rule was enacted on June 26, 2003.[65] The new Rule is composed of three sections.

1. Rule 13b2-2(a)

Section (a) prohibits directors or officers of an issuer from directly or indirectly making material false statements or omissions to accountants in connection with audits or financial statements intended for audit purposes or for SEC filings.[66]

2. Rule 13b2-2(b)

Section (b) prohibits directors, officers, or persons acting on their behalf to "coerce, manipulate, mislead, or fraudulently influence" accountants if they "*knew or should have known*" that it would result in misleading financial statements.[67] This includes issuing reports that do not

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58 17 C.F.R. § 240.13b2-2 (2015).

59 Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1153 (2004).

60 *Id.*; *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1544-45 (2005) (listing the companies that went bankrupt during this time period).

61 Kevin Rubinstein, *Internal Whistleblowing and Sarbanes-Oxley Section 806: Balancing the Interests of Employee and Employer*, 52 N.Y.L. SCH. L. REV. 637, 638 (2007).

62 *Id.*

63 Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820-01, 31,820 (Sec. & Exch. Comm'n May 29, 2003) (to be codified at 17 C.F.R. pt. 240) [hereinafter Improper Influence].

64 *See id* at 31,859 n.4.

65 *See id* at 31,820.

66 17 C.F.R. § 240.13b2-2(a) (2015).

67 17 C.F.R. § 240.13b2-2(b)(1) (2015) (emphasis added).

conform to generally accepted accounting principles ("GAAP"), failing to report in violation of GAAP, and failing to disclose or withdraw a report after it has been deemed misleading.

3. Rule 13b2-2(c)

Section (c) of the Rule applies the same standards applied in sections (a) and (b) to investment companies registered under the Investment Company Act of 1940.[68]

E. What is Scienter?

The Supreme Court has defined scienter as "intent to deceive, manipulate, or defraud."[69] *Black's Law Dictionary* defines scienter as "a degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission."[70] Recklessness can also constitute scienter.[71] The conduct of a corporate officer is reckless when that officer is acting with an "extreme departure from the standards of ordinary care" and in a way that can cause misleading information to reach the investing public, if the danger that misleading information can reach the investing public is known or when the danger is so clear that it should have been known.[72]

Proving scienter requires a demonstration of the defendant's state of mind.[73] For the SEC to prevail in an enforcement action which contains a scienter element, the Commission must show that the defendant knew or should have known that their act or omission was fraudulent.[74] Scienter is typically the most difficult element of a crime to prove because of the difficulty in proving a state of mind.[75]

Complexities in proving scienter make it the element defendants frequently use as a basis for dismissal of charges.[76] Complications arise when a representative, genuinely ignorant of the falsity of the information provided to them, disseminates the false information.[77] The theory of

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68 17 C.F.R. § 240.13b2-2(c) (2015).

69 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

70 *See* BLACK'S LAW DICTIONARY, *supra* note 2.

71 SEC v. Dain Rauscher Inc., 254 F.3d 852 (9th Cir. 2001).

72 *Id.* at 856.

73 Ryan G. Meist, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1105 (1998).

74 *Id.*

75 *Id.*

76 Browning Jeffries, *The Implications of* Janus *on Issuer Liability in Jurisdictions Rejecting Collective Scienter*, 43 SETON HALL L. REV. 491, 494 (2013).

77 *Id.*

collective scienter attempts to remedy this situation.[78] Collective scienter attributes the requisite scienter to the organization as a whole when the individuals perpetrating the underlying fraud cannot be identified.[79] Many jurisdictions reject collective scienter and continue to require the scienter of the individual asserting the fraudulent information to be proven.[80]

A comparison of scienter with conceptions of mens rea relevant to criminal cases illuminates distinctions and the ultimate problems associated with the incorporation of a scienter requirement in Rule 13b2-2. Historically, the state of mind of the accused has been an important element in the United States' system of justice.[81] Lawmakers have often included the words "willful" and "malicious" in criminal statutes to establish intent, or mens rea[82] required for a conviction.[83] Mens rea has a broader scope of culpability than scienter.[84] Negligence is the broadest tier of mens rea, creating culpability when the actor "should be aware of a substantial and unjustifiable risk."[85] Recklessness builds on negligence by specifying a heightened requirement of "conscious disregard" of the substantial and unjustifiable risk.[86] Knowledge creates further culpability because the actor is "aware that it is practically certain that [the] conduct will cause a certain result."[87] The most culpable level of mens rea is purpose—consciously engaging in some conduct with the intention of causing the result.[88]

Mens rea is a legal element of crime intended to protect the public from undeserved punishment.[89] Scienter is analogous to mens rea and is typically required in civil cases.[90] Unlike mens rea, scienter does not include culpability for negligence.[91] Knowledge requirements have their roots in the common law.[92] Courts relied on the level of a defendant's

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78 *Id.* at 494-95.

79 *Id.* at 495.

80 *Id.*

81 Michael L. Seigel, *Bringing Coherence to Mens Rea Analysis for Securities-Related Offenses*, 2006 WIS. L. REV. 1563, 1564 (2006).

82 BLACK'S LAW DICTIONARY, *supra* note 2, at 1006 (defining mens rea as: [Law Latin "guilty mind"] (1861) "The state of mind that the prosecution, to secure a conviction, must prove that a defendant had when committing a crime; criminal intent or recklessness").

83 Seigel, *supra* note 81, at 1564.

84 *Id.* at 1571.

85 *Id.* at 1572 (citing MODEL PENAL CODE § 2.02(2)(c) (1985)).

86 *Id.*

87 *Id.*

88 *Id.*

89 *Id.* at 1569.

90 *Id.* at 1604.

91 SEC v. Dain Rauscher Inc., 254 F.3d 852, 856 (9th Cir. 2001).

92 Jeanne P. Bolger, *Recklessness and the Rule 10b-5 Scienter Standard After* Hochfelder, 49 FORDHAM L. REV. 817, 822 (1981).

knowledge and intent to determine culpability and the severity of the sentence, if any.[93] Accordingly, one who causes the death of another may have committed murder, but, because of a lack of intent, may be acquitted.[94] Similarly, for securities fraud charges requiring proof of scienter, the accused can escape liability by showing a lack of scienter.[95]

Of course, criminal charges of any kind can be brought by governmental entities only; individuals cannot bring criminal charges.[96] Violation of criminal laws generally results in the loss of life, liberty, property, or a combination thereof.[97] Civil suits can be brought by governments or by individuals.[98] Civil remedies can be loss of property in the form of fines or injunctive relief, but not imprisonment.[99] Civil laws can be broken down further into two classes: those that include a private cause of action and those that can be enforced only by the government.[100] Civil laws that include a private cause of action may include elements to protect individuals from frivolous lawsuits designed to compel a settlement.[101] Civil laws lacking a private cause of action exist to allow the government to protect the public and enforce laws; such laws may have lower pleading requirements and fewer elements to prove.[102]

F. A Point of Confusion

While seemingly similar, there is an important distinction to be made between fraud charges relating to GAAP non-compliance and charges brought for a violation of Rule 13b2-2. Generally, scienter is an element that must be proven to prevail on fraud charges in relation to GAAP non-compliance.[103] Simply publishing inaccurate information may not

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93 *Id.* at 822-23.

94 *See, e.g.*, Regina v. Cunningham, 41 Crim. App. 155 (1957).

95 *See generally* SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011); United States v. Goyal, 629 F.3d 912 (9th Cir. 2010).

96 John Bronsteen et al., *Happiness and Punishment*, 76 U. CHI. L. REV. 1037, 1037-38 (2009) (contrasting criminal and civil suits); *see also* Leeke v. Timmerman, 454 U.S. 83, 85 (1981) (affirming lower court holding that "a private citizen lacks a judicially cognizable interest in the prosecution or non-prosecution of another").

97 *See also* Meghan J. Ryan, *Death and Rehabilitation*, 46 U.C. DAVIS L. REV. 1231 (discussing death penalty); *see generally Leeke*, 454 U.S. at 85.

98 Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1814 (1992).

99 *Id.* at 1812.

100 Susan J. Stabile, *The Role of Congressional Intent in Determining the Existence of Implied Private Rights of Action*, 71 NOTRE DAME L. REV. 861, 861 (1996).

101 Mann, *supra* note 98, at 1814.

102 Dain C. Donelson & Robert A. Prentice, *Scienter Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications*, 63 CASE W. RES. L. REV. 441, 448 (2012).

103 SEC v. Todd, 642 F.3d 1207, 1218 (9th Cir. 2011).

necessarily prove scienter, but significant violations *may indicate* scienter.[104] An important distinction to make is that Rule 13b2-2 is not a rule about accounting and proper accounting methods.[105] Instead the Rule forbids making false statements or material omissions with respect to the company's financials to accountants preparing reports for the SEC or for audit purposes.[106] Therefore to analogize Rule 13b2-2 to the scienter requirement for GAAP violations is improper. This Rule is about communication and withholding information, not the methods used by the accountants to arrive at their reported results.

II. The Ninth Circuit Case History

Current precedent in the Ninth Circuit requires the SEC to prove scienter to prevail on a Rule 13b2-2 action.[107] The most recent case from the Ninth Circuit is *SEC v. Todd*, which relied heavily on *United States v. Goyal*.[108]

A. United States v. Goyal

Goyal, decided in 2010, was a criminal case brought by the United States Attorney's Office in the Northern District of California against Prabhat Goyal, the CFO of NAI, a security software firm.[109] Goyal was charged with, among other things, violations of Rule 13b2-2.[110] The government contended that Goyal made materially false statements to PricewaterhouseCoopers ("PwC"), the outside auditors to NAI.[111]

In 1998, NAI expanded from a direct sales distribution method by entering into sales agreements with distribution companies.[112] The government took issue with NAI's recording of revenue from these sales agreements, asserting that NAI prematurely recognized the revenues to be received and causing revenue to be overstated on the company's financial reports.[113] Specifically, Goyal was accused of misleading PwC in letters he signed attesting that NAI's accounting conformed with GAAP and that NAI

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104 *Id*. (citing Dannenberg v. Painewebber Inc. (*In re* Software Toolworks Inc.), 50 F.3d 615, 627 (1994)).

105 *See generally* 17 C.F.R. § 240.13b2-2 (2015).

106 *See generally id.*

107 *Todd*, 642 F.3d at 1225.

108 *See id*. at 1219.

109 *See generally* United States v. Goyal, 629 F.3d 912 (9th Cir. 2010).

110 *Id*. at 914.

111 *Id*.

112 *Id*. at 913.

113 *Id.* at 914.

disclosed all sales terms.[114]

A jury convicted Goyal on seven counts of making materially false statements to PwC.[115] Upon the district court's denial of Goyal's motion for judgment of acquittal and for a new trial, Goyal brought an appeal before the Ninth Circuit.[116] The court, interpreting 15 U.S.C. § 78, held that the government was required to prove scienter, that is, show Goyal knew his statements were false, for him to be *criminally* liable.[117] Analyzing Rule 13b2-2, the court noted "*[c]riminal* liability under Rule 13b2-2 therefore also requires that a false statement to an auditor be made knowingly."[118] The Ninth Circuit reversed the judgment of the district court, holding that the government had failed to prove that Goyal knowingly deceived NAI's auditors, and therefore, as a matter of law, a jury could not have found him guilty.[119]

B. SEC v. Todd

In 2011, the Ninth Circuit decided *SEC v. Todd*.[120] In *Todd*, the SEC sued Todd, Weitzen, and Manza, the CFO, CEO, and controller, respectively, of Gateway, a computer manufacturer and retailer.[121] As controller, Manza was responsible for preparing Gateway's financial statements.[122] Todd's responsibilities included reviewing and signing the company's financial reports.[123] Weitzen and Todd participated in a conference call touting "accelerating revenue growth," and Weitzen prepared a press release stating the company had experienced "accelerated year-over-year revenue growth."[124] Amid a weakening demand for personal computers and record revenue reports by the company, the SEC investigated Gateway's claims.[125]

During fiscal year 2000, a number of transactions were recorded improperly, artificially inflating revenue.[126] Gateway sold fixed assets to another company, Lockheed, which then leased the assets back to

114 *Id.* at 916.
115 *Id.* at 914.
116 *Id.*
117 *Id.* at 916.
118 *Id.* at 922 n.6 (emphasis added).
119 *Id.* at 922-23.
120 *See generally* SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011).
121 *Id.* at 1212.
122 *Id.* at 1213.
123 *Id.* at 1212.
124 *Id.* at 1213.
125 *Id.*
126 *Id.* at 1213-14.

Gateway.[127] Nevertheless, Gateway recorded the asset sale as revenue, a violation of GAAP.[128] Gateway had a sales agreement with VenServ that required a minimum number of referrals before Gateway would receive payment.[129] Gateway had not yet met the threshold, and accordingly had not yet been paid, but still reported the anticipated revenue.[130] An agreement with America Online ("AOL") was modified, changing the timing of payments to Gateway, resulting in a $72 million revenue boost.[131] The officers failed to disclose that this was not sustainable revenue growth, but instead a one-time transaction.[132]

The SEC brought a suit against Todd and Manza alleging, among other things, a violation of Rule 13b2-2 for preparing and delivering false financial statements to PwC, Gateway's outside accountant and auditor.[133] Weitzen's alleged violation of Rule 13b2-2 stemmed from his signing the statements delivered to PwC.[134]

On the Rule 13b2-2 claim, the district court granted summary judgment for Weitzen.[135] A jury found Todd and Manza liable for violating Rule 13b2-2, but the district court granted motions as a matter of law to set aside the jury verdict.[136] The SEC appealed the district court decisions.[137]

On appeal, the Ninth Circuit, relying on *United States v. Goyal*, asserted that scienter was an element of Rule 13b2-2[138] and affirmed summary judgment in favor of Weitzen.[139] The court held that the SEC failed to prove scienter because it had not shown Weitzen had knowledge of the improperly booked transactions.[140] Similarly, Todd and Manza's judgments were affirmed because, based on the facts presented by the SEC, they did not know the letter to PwC was a false representation of the company's financials; they therefore lacked scienter.[141] Vital to the analysis of these two cases is that the court failed to distinguish between the criminal liability that Goyal was facing and the civil liability of Todd, Manza, and

127 *Id.*
128 *Id.* at 1213.
129 *Id.* at 1214.
130 *Id.*
131 *See id.*
132 *Id.*
133 *Id.* at 1219.
134 *Id.* at 1224.
135 *Id.* at 1214.
136 *Id.*
137 *Id.*
138 *Id.* at 1220, 1224.
139 *Id.* at 1224.
140 *Id.*
141 *Id.* at 1219.

Weitzen.

III. THE SECOND CIRCUIT CASE HISTORY

The Second Circuit is home to Wall Street—the financial hub of the Americas, if not the world.[142] Accordingly, many securities-related cases arise in the Second Circuit.[143]

A. SEC v. McNulty

In 1998, the Second Circuit decided *SEC v. McNulty*.[144] McNulty controlled two auto parts businesses, which raised a combined total of seventy-eight million dollars from investors between 1988 and 1990.[145] Portions of the funds raised by McNulty were diverted to other entities controlled by McNulty.[146] This information was not communicated to investors.[147] John Shanklin, a co-defendant, was an officer and director of both auto parts businesses, and was responsible for both companies' accounting and SEC filings.[148]

The SEC alleged that Shanklin misrepresented or concealed the diverting of funds away from their intended purpose.[149] Further, they asserted that Shanklin knew or was reckless in failing to know about the misrepresentations.[150] After failing to file an answer to the allegations, the court entered a default judgment against Shanklin and McNulty.[151]

Shanklin hired new counsel, and moved to vacate the default judgment against him.[152] He argued that, among other things, the SEC did not prove all elements of the claim because it failed to prove that he acted with scienter.[153] Although Shanklin admitted to signing false and incomplete disclosure forms for the SEC, he denied involvement in raising funds or knowledge of any misstatements in corporate filings.[154] The court held that section 13 of the 1934 Act and the SEC rules established thereunder "are

142 Shaun Mulreed, *Private Securities Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 from Achieving Its Goals*, 42 SAN DIEGO L. REV. 779, 807 (2005).

143 *Id.* at 807.

144 SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1998).

145 *Id.* at 734.

146 *Id.*

147 *Id.*

148 *Id.*

149 *See id.*

150 *Id.*

151 *Id.* at 735.

152 *Id.*

153 *Id.*

154 *See id.*

provisions under which civil liability may be imposed without proof of scienter."[155] The court quoted its original opinion, describing Shanklin as a "sophisticated businessman," agreeing that he should be "responsible for the accuracy of the information" in the filings he signed.[156] The court held that Shanklin could not escape liability for misinformation contained in filings that he signed by blaming the preparer for their content.[157] In this regard, the court held Shanklin to a strict liability standard; he signed the filings and was therefore responsible for their content.[158]

B. SEC v. Espuelas

The United States District Court for the Southern District of New York heard *SEC v. Espuelas* in 2010.[159] In *Espuelas*, the defendants were officers and directors of StarMedia, an Internet portal targeting Spanish and Portuguese markets.[160] The SEC's allegations revolved around the revenue reported by StarMedia.[161] The company was engaged in "barter transactions."[162] StarMedia sold advertising to generate revenue.[163] Under a reciprocal agreement, StarMedia would then purchase an equal dollar amount of advertising, resulting in a net zero revenue effect.[164] StarMedia failed to report these transactions as barter transactions, instead booking them as independent transactions.[165] The result was overstated revenue.[166] The company also engaged in contingent transactions, which artificially boosted revenue.[167] In these transactions, the company would present proposed advertising services to a client.[168] If the client accepted the proposal, the company would receive a larger sum than if the proposal was rejected.[169] The company would include the full revenue before the

155 *Id.* at 736.

156 *Id.* at 736 (quoting SEC v. McNulty, No. 94-CIV-7114(MBM), 1996 WL 422259, at *7 (S.D.N.Y. July 29, 1996)).

157 *Id.*

158 BLACK'S LAW DICTIONARY, *supra* note 2, at 1644 (defining a wrong of strict liability as "a wrong in which a *mens rea* is not required because neither wrongful intent not culpable negligence is a necessary condition of responsibility").

159 *See generally* SEC v. Espuelas, 698 F. Supp. 2d 415 (S.D.N.Y. 2010).

160 *Id.* at 418.

161 *Id.* at 419.

162 *Id.*

163 *Id.*

164 *See id.*

165 *Id.*

166 *Id.*

167 *Id.* at 434.

168 *Id.* at 421.

169 *Id.*

proposal was accepted, fraudulently inflating revenue.[170]

StarMedia's officers and directors signed letters to their independent auditing firm Ernst & Young attesting that their "receivables represent valid claims . . . and do not include amounts for . . . other types of arrangements not constituting sales."[171] They also claimed to have included all sales agreements and asserted that no fraud was perpetrated by employees of the company, yet none of the reciprocal agreements or contingent agreements were communicated to the outside auditors.[172]

The SEC brought charges against StarMedia officers for violating a multitude of Exchange Act rules, including SEC Rule 13b2-2 and other rules under section 13 of the Exchange Act.[173] The officers moved to dismiss the charges against them, but the court denied the motions.[174] The court stated there was no question materially misleading statements were made in letters to the independent auditor.[175] Accordingly, the court relied on *SEC v. McNulty*, holding that Rule 13b2-2 does not require the SEC to plead and prove scienter.[176]

IV. ANALYSIS: SUPPORTING THE SECOND CIRCUIT VIEW

Rule 13b2-2 is an important tool for the SEC to carry out their mission of protecting investors; maintaining fair, orderly and efficient markets; and facilitating capital formation.[177] Aside from the legal reasons, there are valid policy reasons supporting the Second Circuit's holding that the SEC need not prove scienter to prevail in civil actions to enforce Rule 13b2-2.

A. The Ninth Circuit's Error

When deciding *SEC v. Todd*, the Ninth Circuit used a criminal case holding to decide a civil case, failing to distinguish between the two.[178] This blurs the important fundamental distinctions between civil and criminal penalties and undermines the unique purposes of criminal and civil laws. A guilty verdict in criminal cases can result in imprisonment, fines,

170 *Id.*

171 *Id.* at 423 (quoting Amended Complaint at 116, SEC v. Espuelas, 698 F. Supp. 2d 415 (S.D.N.Y. 2010)) (discussing the misrepresentations made to Ernst & Young in the letters from the officers).

172 *Id.*

173 *Id.* at 434.

174 *Id.* at 436.

175 *Id.*

176 *Id.* at 436 (citing SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1998)).

177 *See* Improper Influence, *supra* note 63.

178 SEC v. Todd, 642 F.3d 1207, 1219 (9th Cir. 2011) (citing United States v. Goyal, 629 F.3d 912 (9th Cir. 2010), a criminal case, in support of a knowingly standard to be used in *Todd*, a civil case).

probation, restitution, or death.[179] Therefore, proof beyond a reasonable doubt is required to convict on a criminal charge given the enhanced severity of possible penalties.[180] Civil remedies, on the other hand, result in less onerous punishments, such as monetary awards or some form of injunctive relief.[181] As such, the burden of proof is a preponderance of the evidence, a lower standard.[182] Courts cannot apply the same burden of proof standards to civil and criminal cases.[183]

To be punished criminally, one must act with some degree of scienter or mens rea.[184] If scienter is a required element for civil liability, it may be necessary to specifically identify it as such.[185] The Ninth Circuit analogized *Goyal*, a criminal case, to *Todd*, a civil case, to determine that scienter is required for liability under Rule 13b2-2.[186] Scienter is not an express element of Rule 13b2-2.[187] Because *Todd* was a civil case brought by the SEC for violation of a rule which does not require scienter, the Ninth Circuit erroneously relied on *Goyal* by holding that scienter was required for the respondents to be held civilly liable for their actions.

The Ninth Circuit instead should have looked to cases such as *McNulty*, which were analogous but not binding, to hold that a civil action brought by the SEC under a rule that does not require scienter should not be held to a higher requirement—requiring scienter.

B. Legislative Intent: Sarbanes-Oxley

In 2002, Congress enacted Sarbanes-Oxley to prevent a repeat of the accounting frauds that led to large corporate bankruptcies, market declines, and investor losses.[188] The Act required the SEC to create or amend rules to

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179 Joseph L. Lester, *Presumed Innocent, Feared Dangerous: The Eighth Amendment's Right to Bail*, 32 N. KY. L. REV. 1, 32 (2005).

180 Elizabeth A. Ryan, *The 13th Juror: Re-Evaluating the Need for a Factual Sufficiency Review in Criminal Cases*, 37 TEX. TECH. L. REV. 1291, 1299 (2005).

181 Sharon Finegan, *The False Claims Act and Corporate Criminal Liability:* Qui Tam *Actions, Corporate Integrity Agreements and the Overlap of Criminal and Civil Law*, 111 PENN ST. L. REV. 625, 626 (2007).

182 Ryan, *supra* note 180, at 1299; *see also* Margaret H. Lemos, *The Commerce Power and Criminal Punishment: Presumption of Constitutionality or Presumption of Innocence?*, 84 TEX. L. REV. 1203, 1205 (explaining that criminal prosecution is worse than civil sanction and therefore triggers distinct rights and duties).

183 Ryan, *supra* note 180, at 1299.

184 Siegel, *supra* note 81, at 1569.

185 *See* Lambert v. California, 355 U.S. 225, 229 (1957).

186 SEC v. Todd, 642 F.3d 1219, 1219 (9th Cir. 2011).

187 17 C.F.R. § 240.13b2-2 (2015).

188 Johnson & Sides, *supra* note 59, at 1153; *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301-08, 116 Stat. 745, 775-85 (2002).

regulate corporate responsibility for accurate financial reporting.[189] Most relevant to this analysis are sections 302 and 303 of Title III, titled "Corporate Responsibility for Financial Reports."[190]

Section 302 was an expression of Congress's intention to hold corporate officers responsible for the accuracy of the information they disseminate.[191] The section requires the SEC to create rules creating corporate officer accountability.[192] Specifically, officers are held responsible for their organization's internal controls,[193] must disclose deficiencies and fraud to auditors,[194] and disclose changes in internal controls.[195] Furthermore, officers who sign quarterly and annual financial reports must review the reports[196] to ensure the reports do not contain material misstatements or omissions,[197] and fairly represent the company condition.[198]

By enacting section 303, Congress verbalized its intention to protect the public interest and the interests of investors.[199] Section 303 declares unlawful any action that will mislead auditors for the purpose of causing the auditors' financial reports to be materially misleading.[200] The SEC is granted *exclusive* jurisdiction to enforce, in civil proceedings, any rule or regulation issued under this section.[201] There is no mention of "knowing" violations or "scienter" in the enabling statute.[202] Accordingly, a scienter element should not be added to Rule 13b2-2 based on legislative intent because it was promulgated under section 303. A court ruling that requires the SEC to prove scienter is tantamount to the court rewriting the enabling statute.

C. Subsequent SEC Rulemaking

Based on section 303(a) of Sarbanes-Oxley, the SEC proposed an amendment of then-existing Rule 13b2-2 to conform to the new law.[203] In

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189 *See* Sarbanes-Oxley Act § 101.
190 *Id.* at § 302.
191 *Id.*
192 *Id.* at § 302(a).
193 *Id.* at § 302(a)4.
194 *Id.* at § 302(a)5.
195 *Id.* at § 302(a)6.
196 *Id.* at § 302(a)(1).
197 *Id.* at § 302(a)2.
198 *Id.* at § 302(a)3.
199 *Id.* at § 303(a).
200 *Id.*
201 *Id.* at § 303(b).
202 *See generally id.* at §§ 302-03.
203 Improper Influence on Conduct of Audits, 67 Fed. Reg. 65,325, 65,325 (Oct. 24, 2002) (to be

October of 2002 the proposed Rule was published in the Federal Register for notice and comment.[204] Specifically, the Commission solicited comments on the wording of the Rule addressing certain actions "to coerce, manipulate, mislead or *fraudulently* influence" auditors.[205] The SEC included this language to address these actions, creating civil liability for them regardless of the effect on audit results.[206] The Commission explicitly stated in the Rule proposal that the word "fraudulently" modified the word "influence" exclusively, and did not apply to the coercion, manipulation, or misleading elements of the Rule.[207]

The SEC received comments suggesting that "fraudulently" should modify all of the actions, not only the influence aspect of the Rule.[208] Others suggested a materiality aspect to the misleading element, or that "any attempt to purposely skew the issuer's disclosure should violate the [R]ule."[209] Ernst & Young, one of the "Big Four" international accounting firms,[210] suggested that fraudulent intent should not be required for officers or directors, but should be required for third parties.[211] The SEC ultimately decided that the "fraudulently" modifier would apply only to the verb "influence."[212] To clarify the Rule, "fraudulently influence" was placed at the end of the sentence to ensure that only "influence" was subject to the "fraudulently" modifier.[213]

Addressing the other comments, the Commission specified that Rule 13b2-2 historically prohibited making, or causing to be made, materially misleading statements to auditors, and the new Rule would not modify the existing standard.[214] The SEC reiterated that the purpose of Sarbanes-Oxley is to restore investor confidence in financial reporting, and decided that

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codified at 17 C.F.R. pt. 240).

204 *Id.*

205 Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (to be codified at C.F.R. pt. 240) (emphasis added).

206 *Id.*

207 *Id.*

208 *Id.*

209 *Id.*

210 The term "big four" originates from the term "big eight," which was coined in the 1960s to describe the top eight largest international accounting firms. Throughout the years, the firms consolidated to five top firms. After the Enron scandal, Arthur Andersen ceased operations leaving the remaining "big four" as they are known today. *See* JAMES BROCK, THE STRUCTURE OF AMERICAN INDUSTRY 332 (12th ed.) (citing S.A. ZEFF, HOW THE US ACCOUNTING PROFESSION GOT WHERE IT IS TODAY: PART I 191-95 (2013) (explaining the origin of the term "Big Eight"). *See generally Big Four (audit firms)*, WIKIPEDIA.COM, http://en.wikipedia.org/wiki/Big_Four_auditors (last visited Mar. 19, 2014).

211 Improper Influence on Conduct of Audits, *supra* note 205, at 31,820.

212 *Id.* at 31,823.

213 *Id.*

214 *Id.*

"imposing what would amount to a new scienter requirement on the preexisting provision prohibiting officers and directors from causing misleading statements or omissions to be made to auditors" would be contrary to the intent of the Act.[215]

D. Deference to SEC Interpretation

There are two deference standards that courts may apply to determine whether to defer to an agency interpretation: *Skidmore* deference and *Chevron* deference.[216] *Chevron* deference is more frequently cited by the Supreme Court, and is a very deferential standard.[217] *Chevron* is often used when agencies use formal rulemaking, or rulemaking utilizing notice and comment rulemaking—as the SEC did with the promulgation of 13b2-2.[218] *Skidmore* is used less often, and is less deferential.[219] *Skidmore* is more frequently used for interpretive rules, which do not utilize notice and comment periods.[220] Under both doctrines, courts generally will defer to an administrative agency's interpretation of the authority granted to it.[221] In the interest of thorough analysis, a brief *Skidmore* discussion will be followed by a deeper *Chevron* analysis.

1. *Skidmore* Deference

Skidmore v. Swift was a Supreme Court case to determine whether to defer to an interpretive bulletin issued by the Administrator of Labor.[222] The employees verbally agreed to sleep on premises, and receive overtime pay only when answering alarms.[223] The employees then sued their employer for overtime pay for all their time spent on call, including when they were sleeping on premises.[224] Lower courts dismissed the workers' suit.[225] The Administrator of Labor bulletin suggested a flexible solution to consider the freedom of the employee to engage in personal activities, rather than an "all-in" or "all-out" approach to "on call" pay.[226] Deferring to the agency, the Supreme Court reversed the lower courts, allowing the

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215 *Id.*

216 Bradley Lipton, *Accountability, Deference, and the* Skidmore *Doctrine*, 119 YALE L.J. 2096, 2123 (2010).

217 *Id.*

218 *Id.* at 2123.

219 *Id.* at 2098.

220 *Id.* at 2123.

221 *Id.* at 2120.

222 Skidmore v. Swift, 323 U.S. 134 (1944).

223 *Id.* at 135.

224 *Id.*

225 *Id.*

226 *Id.* at 138.

case to be heard to determine if the employers should determine if, and how much, employees should be compensated for this time where they may not be working, but are still limited in where they can go or what they *can* do.[227] The Court acknowledged that the agency interpretations are not binding on the Court, but that interpretations do "constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance."[228]

It logically follows, therefore, that a court would likely defer to the SEC interpretation of the laws and rules based on its vast experience in securities law. *Skidmore* deference, applied to SEC's interpretation of Rule 13b2-2, would likely relieve the SEC from the need to prove scienter to prevail in a civil enforcement case.

2. *Chevron* Deference

Courts would more likely apply the *Chevron* doctrine when analyzing deference standards, because Rule 13b2-2 was subject to notice and comment, and was not merely an interpretive rule.[229] So long as the enabling statute was ambiguous, and the agency interpretation is reasonable, *Chevron* deference will apply.[230] *Chevron v. Natural Resources Defense Council* is a Supreme Court case establishing a two-part test.[231] The first part of the test is to determine if Congress' intent was clear, or if the statute is ambiguous.[232] If the statute is found to be ambiguous, the court will move to the second part of the analysis, deciding if the agency interpretation was permissible based on the statute as written.[233]

The *Chevron* case involved the Clean Air Act passed by Congress, which required polluters to obtain a permit before constructing any new or modified "stationary sources" of pollution.[234] In interpreting the statute, the EPA promulgated a rule creating a "bubble policy" regarding the stationary sources,[235] grouping together pollution emitting devices within a facility.[236] As a result, modifications to equipment occurring within a "bubble" would not require the permit under the EPA regulation.[237]

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227 *Id.* at 139-40.

228 *Id.* at 140.

229 Jim Rossi, *Respecting Deference: Conceptualizing* Skidmore *Within the Architecture of* Chevron, 42 WM. & MARY L. REV. 1105, 1108 (2001).

230 Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

231 *Id.* at 842-43.

232 *Id.*

233 *Id.* at 843.

234 *Id.* at 848-49.

235 *Id.* 840-41.

236 *Id.* at 840.

237 *See id.* at 855.

The Natural Resources Defense Council ("NRDC") is one of several environmental-action groups who sought judicial review of the EPA regulation of permit requirements for modifications, or new construction, within an existing "bubble."[238] The United States Court of Appeals for the District of Columbia set aside the regulation, holding that the EPA "bubble policy" did not appropriately define a polluting facility.[239]

The Supreme Court overturned the appellate court decision.[240] First, the Court analyzed the enabling statute, the Clean Air Act, finding that the Act "does not explicitly define what Congress envisioned as a 'stationary source' to which the permit program . . . should apply."[241] Nor could intent be ascertained in the legislative history.[242] Finding the meaning of a stationary source to be ambiguous in the statute, the Court moved to the second part of the test, holding that the agency interpretation "represented a reasonable accommodation of manifestly competing interests and was entitled to deference."[243] *Chevron* is the primary basis for judicial deference to agency interpretations when statutes are ambiguous, and the agency interpretation is reasonable.[244]

E. Rule 13b2-2 Deference Analysis Under *Chevron*: The Ambiguity Element

The first part of the analysis under *Chevron* is to determine if the enabling statute is ambiguous as to a scienter requirement.[245] The enabling statute, Sarbanes-Oxley § 303, is divided into four parts. Part (a) is the substantive law that will be analyzed for ambiguity.[246] Parts (b), (c), and (d) discuss enforcement authority, preemption of other laws, and deadlines for SEC rulemaking respectively.[247]

Section 303(a) charges the SEC with creating rules as it deems "necessary and appropriate" to protect the public and investors from

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238 *Id.* at 837.

239 *Id.* at 841.

240 *Id.* at 866.

241 *Id.* at 837.

242 *Id.*

243 *Id.* at 865.

244 *See generally* Nat'l Cable & Telecomms. Ass'n. v. Brand X Internet Servs., 545 U.S. 967 (2005) (holding the enabling statute was ambiguous in defining "telecommunications service," and the FCC interpretation was a reasonable policy choice, therefore the FCC is entitled to *Chevron* Deference); Bankers Life & Cas. Co. v. United States, 142 F.3d 973 (7th Cir. 1998) (holding that the plain language of the statute failed to expressly provide a valuation method, and the agency interpretation was not unreasonable given the purpose of the statute, granting *Chevron* Deference to the IRS).

245 *Chevron*, 467 U.S. at 843.

246 Sarbanes-Oxley Act of 2002 § 303(a), Pub. L. No. 107-204, 116 Stat. 745, 778 (2002).

247 *Id.* at § 303(b)-(d).

misinformation provided to auditors by directors and officers of companies.[248] Specifically, the statute forbids officers or directors, or anyone acting at their behest, from taking "any action to fraudulently influence, coerce, manipulate, or mislead" accounting professionals or auditors "for the purpose of rendering such financial statements materially misleading."[249]

Ambiguity arises in the statute when determining whether misinformation must be given intentionally, or whether negligence is enough for a violation to occur. Notably, the statute "contains no words indicating that Congress intended to impose a 'scienter' requirement," such as knowingly or willfully.[250] *Criminal* liability for rule violation expressly carries a "knowingly" requirement.[251] However, the SEC may only bring *civil* enforcement cases against defendants.[252] Because the statute expressly mentions criminal enforcement, but is silent on civil enforcement, ambiguity exists as to a scienter requirement for civil enforcement. This ambiguity leads to part two of the *Chevron* test, to determine if the SEC interpretation is reasonable.[253]

F. Rule 13b2-2 Deference Analysis Under *Chevron*: The Reasonableness Element

Interpretations made by the SEC regarding the Rule are reasonable, and therefore entitled to deference as long as they are not (1) arbitrary and capricious, or (2) contrary to the language of the statute.[254]

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248 *Id.* The language of the statute is as follows:

> (a) Rules to prohibit
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> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

249 *Id.*

250 McConville v. SEC, 465 F.3d 780, 789 (2006) (citing Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices, Exchange Act Release No. 34,15570, 16 SEC Docket 1143, 1151 (February 15,1979)); *see also* 17 C.F.R. 240.13b2-2 (stating that no director or officer of an issuer, in connection with an audit or examination of the issuer's financial statements or the preparation of any document or report to be filed with the Commission, directly or indirectly shall (a) make or cause to be made a materially false or misleading statement to an accountant or (b) omit to state, or cause another person to omit to state, any material fact necessary to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant).

251 15 U.S.C. § 78m(b)(4)-(5).

252 *Securities Fraud*, *supra* note 47, at 1275.

253 Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865 (1984).

254 *McConville*, 465 F.3d at 786; *see also Chevron*, 467 U.S. at 844.

1. Arbitrary and Capricious (Rational Basis)

The arbitrary and capricious test, established by the Supreme Court in the early 1940's and also known as the "rational basis" test, was codified in 1946 in the APA, providing a basis for judicial review of agency actions.[255] The test consists of two factors.[256] First, the rule will be analyzed to determine if it furthers a legitimate statutory governmental purpose, as opposed to a general governmental purpose.[257] Second, the court must decide if the rule is rationally related to that purpose.[258]

i. Legitimate Statutory Government Purpose

Rule 13b2-2 satisfies the first part of the arbitrary and capricious test because it furthers a legitimate statutory governmental purpose. The Congressional intent was to protect investors from directors and officers who provide information to auditors that may produce misleading results.[259] The resulting Rule created by the SEC clarifies and expands on the original Rule 13B-2 by specifically prohibiting officers and directors from "improperly influencing" auditors.[260] The new Rule also applies these rules to audits of investment company financial statements.[261]

Congress intended for courts, when applying the arbitrary and capricious standard, to consider the agency purpose and means for regulating behavior on a rational basis standard of review.[262]

ii. Rational Relation to the Legitimate Purpose

The SEC interpretation of the enabling statute need not be the only possible interpretation of the statute, or the interpretation that the court would have chosen.[263] The SEC rule simply must be a permissible interpretation of the statutory language.[264] Agency rules should not be disturbed when the rule addresses conflicting policy concerns between the agency, other organizations or the public, and is within the bounds of the

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255 Scott A. Keller, *Depoliticizing Judicial Review of Agency Rulemaking*, 84 WASH. L. REV. 419, 430 (2009).

256 *Id.*

257 *Id.*

258 *Id.*

259 Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (to be codified at C.F.R. pt. 240), *available at* https://federalregister.gov/a/03-13095.

260 *Id*.

261 *Id.*

262 Keller, *supra* note 255, at 431.

263 Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984).

264 *Id.* at 842-43.

enabling statute.[265]

Conflicting policy concerns were indeed considered when Rule 13b2-2 was adopted in 2003.[266] The SEC noted that during the notice and comment period, comments from banking institutions and auditing firms expressed a concern that a negligence standard would cause a "chilling effect" on communications between officers and directors, and between auditors.[267] The SEC claimed these concerns were based on an incorrect assumption; that the SEC has not historically enforced the negligent communication of misleading information in the past.[268] Instead, for many years the SEC has brought enforcement actions of that very type based on the "known or should have known" standard.[269]

A court deciding if a rule is rationally related to the legitimate purpose of the statute must engage in a subjective analysis, but the facts make it hard to argue that it is not. The final rule press release discusses the comments received during the notice and comment period, explaining misconceptions and clarifying the purpose of the rule.[270] It explains the historical and continued use of the negligence standard, and how that relates to the language of the enabling statute.[271] It also affirmed that the commission had no intention to hold parties accountable for "honest and reasonable" accounting errors, as opposed to negligent or intended fraud.[272] The commission also reinforces the underlying policy purpose of restoring investor confidence in the audit process.[273]

2. Contrary to the Language of the Statute

While some may argue that there is no ambiguity in the underlying statute, questioning the validity of the Rule, to argue that the Rule is *contrary* to the statute would be a further stretch. The statute tasks the SEC to create a rule to protect investors by declaring unlawful any actions that can lead to materially misleading financial statements.[274] The Rule that the SEC adopted serves that purpose, and in no way conflicts with the letter or

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265 *Id.* at 845 (citing United States v. Shimer, 367 U.S. 374, 382-83 (1961)).

266 *See* Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (to be codified at C.F.R. pt. 240), *available at* https://federalregister.gov/a/03-13095.

267 *Id.* at nn.33-35.

268 *Id.*

269 *Id.* at n.4.

270 *See generally* Improper Influence on Conduct of Audits, Exchange Act Release No. 26,050, 80 SEC Docket 770 (May 20, 2003) (discussing comments received during the notice and comment period).

271 *Id*. at *4.

272 *Id*.

273 *Id*.

274 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (2002).

spirit of the enabling statute.[275]

To summarize the deference analysis of Rule 13b2-2, *Chevron* analysis is preferred over *Skidmore* analysis because the Rule was created with a notice and comment period, and is not simply an interpretive rule. Applying *Chevron*, the enabling statute is ambiguous as to a scienter requirement, meaning courts will defer to the SEC so long as their rule is reasonable. The Rule is reasonable because it is not arbitrary or capricious, it is rationally related to a legitimate purpose, and it is not contrary to the underlying statute. Therefore, courts should defer to the SEC interpretation of Sarbanes-Oxley section 303, and permit enforcement of Rule 13b2-2 as written, using a negligence standard.

G. Supreme Court Decisions

Before *Hochfelder*,[276] courts generally held that violations of the Securities Acts were held to a negligence standard.[277] From the inception of the SEC in the 1940s, courts used a broad reading of the rules, and evaluated the end result of an action to determine liability.[278] Courts decided the cases based on the facts and the SEC rule, but did not make a thorough scienter analysis.[279] Through the 1960s, courts continued to look at the legislative intent behind the statutes and SEC rules, leaning more towards a negligence standard than a scienter standard.[280] To date, decisions of the circuit courts and Supreme Court have been split regarding the reasoning for, and requirement of, scienter to be proven in SEC enforcement actions.[281]

1. The *Capital Gains* Decision: No Scienter Required

In 1963, an SEC enforcement case came before the Supreme Court to

275 *See* Improper Influence on Conduct of Audits, 68 Fed. Reg. at 31,820.

276 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

277 Charles S. Telly, *Proxies and the Modern Corporation: Scienter Under Sections 14a and 10b of the Securities Exchange Act*, 19 TULSA L. REV. 491, 556 (1984).

278 *See generally In re* Ward LaFrance Truck Corp 13 S.E.C. 373 (1943) (holding that mere failure to disclose material facts to the shareholders created liability); *see also* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d. Cir 1951) (holding that a broad generalized finding of fraud is actionable under securities laws).

279 *See id.*

280 *See* Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (holding that the defendants' assertion that genuine fraud must be alleged and proven is not sufficient. The court stated that "any manipulative device or contrivance" in contravention of the rules was to be read broadly, again affirming that scienter was not an element required for liability.").

281 *See* Aaron v. SEC, 446 U.S. 680 (1980) ("We hold that the scienter requirement enunciated in Hochfelder is not applicable to government enforcement actions brought under §§ 10(b) and 21(d) of the 1934 Act. Consistent with the pre-Hochfelder decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice, for the reasons stated below.").

address the elements required to enforce securities rules.[282] *SEC v. Capital Gains Research Bureau, Inc*. involved a company that issued research reports via subscription.[283] The company purchased shares of securities on six separate occasions before recommending them in a research report.[284] After recommending the securities, the price and volume rose, and the company liquidated its shares to capture a gain.[285] None of the trades were disclosed to the subscribers of the analyst reports.[286]

The SEC requested a preliminary injunction to enforce the Investment Advisors Act of 1940.[287] The district court denied the injunction, holding that the words "fraud" and "deceit" required a knowledge and intent on the part of Capital Gains to injure their clients.[288] The Second Circuit affirmed the district court's decision five-to-four.[289] The dissenting judges opined that the business climate had matured from the inceptions of common law fraud[290] and deceit, and a broader interpretation must be adopted to suit the securities industry.[291]

The Supreme Court granted certiorari to decide whether the securities laws required intent to cause injury, or whether a broad interpretation of the rules should be used.[292] The Court discussed the financial landscape leading to the 1940 Act, and the need for regulation.[293] The Court noted that the Act regulated actions taken by an advisor consciously or subconsciously that may affect the advisor's financial interests.[294] The Court held that Congress "intended the Investment Advisors Act of 1940 to be construed *like other securities legislation* 'enacted for the purpose of avoiding frauds.'"[295] The Court assumed that Congress was not ignorant to the changes in financial landscape since the doctrine of common law fraud was established, and held that securities legislation must be read broadly to

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282 SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180 (1963).
283 *Id.* at 182-83.
284 *Id.* at 183.
285 *Id.*
286 *See id.*
287 *Id.*
288 *Id.* at 184.
289 *Id.*
290 *See* William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 166 (1997) (Under the common law of fraud, to recover damages requires intent to defraud. The SEC seeks injunctive relief and is not a private plaintiff recovering damages. Since the SEC actions are civil enforcement, the common law of fraud should not apply.).
291 SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 185 (1963).
292 *Id.*
293 *Id.* at 188.
294 *Id.*
295 *Id.* at 195 (emphasis added).

encompass the legislative intent of the statutes.[296] Accordingly, the Court reversed the lower court decision, and remanded in favor of the SEC injunction.[297]

2. The *Hochfelder* Decision: Scienter Required

Ernst & Ernst v. Hochfelder was a private action brought by investors under the Securities Act of 1934 against the auditor of a brokerage firm that was responsible for auditing and filing the annual reports of the securities firm.[298] The plaintiffs alleged that Ernst and Ernst ("Ernst") aided and abetted the firm by failing to detect fraudulent actions, in violation of section 10b of the Securities Exchange Act of 1934 and SEC Rule 10b-5.[299] The district court rejected Ernst's contention that fraud charges could not be brought on negligence grounds, but dismissed the case due to inadequate facts to support the action.[300] The Circuit Court reversed, holding that Ernst had a duty to inquire and disclose, and by breaching that duty, was liable to the investors.[301]

The Supreme Court granted certiorari to determine if a private action can succeed absent a finding of "intent to deceive, manipulate, or defraud."[302] The Court looked at the legislative intent of the enabling statute contained in the 1934 Act and subsequent SEC rulemaking.[303] The Court also looked at the language of the statute, and was unconvinced by the suggestion of the SEC that Congressional intent and prior case law lean towards a flexible interpretation, instead holding that the language clearly supported the necessity to prove scienter.[304] The SEC also failed to convince the Court that Congress would explicitly require scienter when it intended to include it as an element, using section 9(e) as an example: "any person who *willfully* participates in any act or transaction . . . ."[305]

The Court explored legislative intent independently, holding Congress failed to explicitly answer whether scienter would be required.[306] "Neither the intended scope of [s]ection 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the

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296 *Id.*
297 *Id.* at 201.
298 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 188 (1976).
299 *Id.* at 190.
300 *Id.* at 191.
301 *Id.* at 192.
302 *See id.* at 193.
303 *Id.* at 196.
304 *Id.* at 201.
305 *Id.* at 207 (emphasis added).
306 *Id.* at 201.

1934 Act . . . ."[307] The Court also quoted from a Senate Report entitled Manipulative Practices, which contains the phrase "[t]he defendant *may* escape liability by showing that the statement was made in good faith."[308] The Court ultimately ruled that the language of the Rule required scienter to be proven for liability, and declined to extend liability to negligent conduct.[309]

The dissent in *Hochfelder* read the language of the SEC rule to apply to negligent and intentional conduct alike.[310] Aside from the language of the statute, the dissent also opined that the statutes were enacted for the "broad, needed, and deserving benefit" of the victim investors.[311]

After the *Hochfelder* decision, district and circuit courts either cited to *Hochfelder*, dismissing for lack of scienter,[312] or distinguished cases to find liability absent scienter.[313] Courts generally held that the *Hochfelder* holding, based on a private action, was not applicable to SEC enforcement actions, and holdings prior to *Hochfelder* continued to be binding.[314] The *Aaron v. SEC* decision would resolve that issue in 1980.

3. The *Aaron* Decision: Scienter Required

Aaron v. SEC applied the decision in *Hochfelder* to the SEC as well as private plaintiffs, and analyzed sections 17(a)(1), (2), and (3) to determine if scienter is a required element to be proven.[315] It is this reasoning and analysis that are important to the present analysis of Rule 13b2-2. Aaron was a manager at a New York broker-dealer.[316] He supervised two brokers who repeatedly disseminated false information about a company, despite warnings from the company itself and lawyers involved with the

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307 *See id.* at 202.

308 *Id.* at 206 (citing S. REP. NO. 73-792, at 13 (1934)).

309 *See id.* at 214.

310 *Id.* at 217.

311 *Id.* at 218.

312 *See, e.g.*, SEC v. Bausch & Lomb, 420 F. Supp. 1226, 1244 (S.D.N.Y 1976) (holding that the Commission had not proven that the defendant acted with the requisite scienter, and therefore defendant was not in violation of Rule 10b-5 or section 10(b) of the Exchange Act).

313 *See generally* SEC v. World Radio Mission, Inc., 544 F.2d 535, 540 (1st Cir. 1976) (holding that a suit for potential future actions does not require a showing of state of mind); SEC v. Geotek, 426 F. Supp. 715, 726 (N.D. Cal. 1976) *aff'd sub nom.* SEC v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979) (holding that the Supreme Court holding in *Hochfelder* requiring scienter on a suit under section 10(b) does not extend to suits under other sections of the Exchange Act); SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1046 (1976) (holding that the Supreme Court did not intend "that those who play an indispensible role in the sale" of unregistered securities to be immune from SEC initiated, injunctive relief).

314 *See Universal Major Indus. Corp.*, 546 F.2d at 1047 (1976).

315 *See* Aaron v. SEC, 446 U.S. 680, 691, 695-96 (1980).

316 *Id.* at 682.

company.[317] Aaron was aware, but failed to prevent the brokers from misleading their clients.[318] The SEC sought an injunction in district court under Rule 10b-5 and sections 17(a)(1), (2), and (3).[319]

The district court granted the injunction, noting that "negligence alone might suffice to establish a violation," but holding that the intentional failure to stop the dissemination of misleading statements was also sufficient to establish scienter.[320] The Second Circuit affirmed, holding that "proof of negligence alone will suffice" for a SEC enforcement action.[321] The Court pointed out that the *Hochfelder* court did not decide whether scienter is required for SEC enforcement actions.[322] The appellate court cited *SEC v. Coven*[323] and its analysis of the scienter requirement under section 17(a), holding that the language of the statute did not require intent, and that Congress considered a scienter requirement, but ultimately "opted for liability without willfulness, intent to defraud, or the like."[324]

The Supreme Court granted certiorari to decide if scienter was a required element of these SEC rules.[325] This analysis can be applied to Rule 13b2-2 as well. Without much analysis, the Court quoted the *Hochfelder* decision, extending that holding to SEC enforcement cases as well.[326] The Court failed to distinguish a private cause of action from an enforcement action, and failed to consider the common law fraud doctrine analysis made by the *Capital Gains* Court.[327] While acknowledging Congressional intent to enact legislation protecting investors against fraud with rules "to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes,'"[328] the Court instead insisted that the language of the statute did not permit an interpretation in line with the intent of Congress.[329]

The Court then picked apart sections 17(a)(1), (2), and (3), holding that 17(a)(1) required a showing of scienter, but 17(a)(2), and (a)(3) did not

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317 *Id.* at 683.
318 *Id.*
319 *See id.* at 684.
320 *Id.*
321 *Id.* at 685.
322 *Id.*
323 SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978).
324 Aaron v. SEC, 446 U.S. 680, 686 (1980) (citing *Coven*, 581 F.2d at 1027-28).
325 *Id.* at 686.
326 *Id.* at 691.
327 *See id.* at 695.
328 *Id.* at 695 (citing Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 151 (1972)) (quoting SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 195 (1963)).
329 *Aaron*, 446 U.S. at 695.

require scienter.[330] In so holding, the Court pointed to the language of 17(a)(1), specifically the words "device," "scheme," and "artifice," which the Court stated "all connote knowing or intentional practices."[331] Section 17(a)(1) also shares the word "device" with Rule 10b-5, and borrowing from the *Hochfelder* analysis, the Court maintained that "device" embraces a scienter requirement.[332]

Analyzing 17(a)(2), the Court held that the language of the Rule did not require scienter, instead looking at the end result, and not the intent behind, the regulated conduct.[333] The Court said the language of the Rule prohibits "any type of material misstatement or omission . . . that has the *effect* of defrauding investors, whether the wrongdoing was intentional or not."[334] Similarly, the Court looked at the language contained in Rule 17(a)(3), specifically language proscribing engagement "in any transaction, practice, or course of business which *operates* or *would operate* as a fraud or deceit."[335] The Court, analogizing 17(a)(3) to the analysis of section 206(2) of the 1940 Act in *Capital Gains*, held that under 17(a)(3), deliberate action is not required to protect investors.[336]

The dissenting opinion in *Aaron* calls for distinguishing between a private action and a SEC enforcement action.[337] Justice Blackmun stated that the language was not as clear as the majority suggested.[338] A historical argument of legal tradition also distinguished between common law fraud at law requiring scienter, and a suit in the court of chancery at equity, that did not require intent.[339] Finally, Blackmun briefly reviewed legislative intent, discussing various state securities laws that led to, and provided a model for federal law.[340] These laws empowered state attorneys general to bring suit for injunctive relief whenever fraudulent conduct was uncovered, intentional or not.[341]

4. Synergy: Analysis of 13b2-2 Based on the Supreme Court Holdings

Applying the holdings in *Capital Gains*, *Hochfelder*, and *Aaron*,

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330 *Id.* at 695-96.

331 *Id.* at 696.

332 *Id.*

333 *Id.*

334 *Id.* at 696 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976)).

335 *Id.* at 697 (citing 15 U.S.C. § 77q(a)(3)) (emphasis in original).

336 *See id.* (comparing section 17(a)(3) to the analysis of § 206(2) of the Investment Advisors Act of 1940 in SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 200 (1963)).

337 *Id.* at 704 (Blackmun, J., dissenting).

338 *Id.* (Blackmun, J., dissenting).

339 *Id.* at 709-11 (Blackmun, J., dissenting).

340 *See id.* at 711 (Blackmun, J., dissenting).

341 *Id.* at 712 (Blackmun, J., dissenting).

scienter should not be an element of SEC enforcement actions under Rule 13b2-2. The Supreme Court has analyzed three major factors when evaluating the securities rules (1) the statutory language, (2) the legislative intent, and (3) historical context.[342]

i. Statutory Language

The Supreme Court has held that words like "device,"[343] "scheme,"[344] and "artifice"[345] are all words that indicate the need to prove scienter. Neither Sarbanes-Oxley section 303(a) nor Rule 13b2-2 contains those terms.[346] Further, the language of Rule 13b2-2 looks to the end result; that is to prevent materially false or misleading information from being communicated to auditors.[347] Neither willfulness nor intent is indicated as a factor in determining whether the Rule has been violated.[348] Like sections 17(a)(2) and (3), Rule 13b2-2 does not require deliberate conduct to carry out the purpose of the Rule to protect investors.[349]

ii. Legislative Intent

The *Capital Gains* Court assumed that Congress, in enacting the statute, was aware of the changing landscape of the securities industry, holding that the securities laws must be interpreted broadly to carry out the intent of Congress, to protect investors.[350] The *Hochfelder* Court discounted the SEC assertions that Congress included the words "willfully" or "intentionally" when required, and referred to a report that indicated that misstatements or omissions made in good faith were not actionable.[351] The *Aaron* Court borrowed from *Hochfelder* in its analysis of section 17(a)(1) looking for legislative intent in the language of the statute.[352] Absent the shared language of Rule 10b-5, the Court looked to the end result that Congress wanted to prevent when analyzing sections 17(a)(2) and (3).[353]

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342 *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Aaron v. SEC, 446 U.S. 680 (1980); SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180 (1963).

343 *See Hochfelder*, 425 U.S. at 214.

344 *See Aaron*, 446 U.S. at 681.

345 *See id.*

346 *See* 17 C.F.R. § 240.13b2-2; *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303(a), 116 Stat. 745, 778 (2002).

347 17 C.F.R. § 240.13b2-2.

348 *See generally id.*

349 *See id.*

350 *See* SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 193 (1963).

351 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205-06 (1976).

352 *See Aaron*, 446 U.S. at 681.

353 *See id.*

Sarbanes Oxley section 303 was enacted in 2002.[354] Based on the Court's jurisprudence in this area of the law it is fair to assume that, if Congress was not aware of the modern financial landscape and how it differs from the days when the doctrine of common law fraud was developed, it is now. Congress is now on constructive notice of the need to be explicit in the realm of securities law, having seen the cases that have come before the various circuit courts and the Supreme Court.[355] And yet, Congress has opted not to use the words "willful" or "intentional" in the statute.[356] The language of the statute does indeed seek to regulate an end result, and as such should be interpreted broadly to carry out its function.

5. Compare and Contrast with other SEC Rules

Omission of an explicit scienter requirement is not conclusive proof that the SEC is not required to prove scienter when enforcing a rule.[357] For instance, Rule 13b2-2 does not contain an explicit scienter requirement.[358] But the SEC has enacted other rules that do not explicitly require scienter, yet the Supreme Court has found scienter to be a required element for finding a violation of the Rule.[359] These rules can be distinguished from 13b2-2 by analyzing the statute and the Supreme Court's jurisprudence.

Arguably the most commonly enforced SEC rule, Rule 10b-5 forbids material misstatements or omissions in connection with the purchase or sale of securities.[360] While the language of the statute does not explicitly require scienter for civil liability, the Supreme Court has held that scienter is required to prevail on a civil 10b-5 charge.[361] Specifically, the Court held

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354 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (2002).

355 *Id.*

356 *Id.*

357 *See generally* 17 C.F.R. § 240.10b-5; *see also* 15 U.S.C. § 77q(a)(1) (2011). The Supreme Court has ruled that these rules, while not explicitly stating a scienter requirement, do require the SEC to prove the element of scienter.

358 *See* 17 C.F.R. § 240.13b2-2.

359 *See* Aaron v. SEC, 446 U.S. 680, 701 (1980) (holding the SEC must prove the element of scienter for a finding of liability for violating Rule 10b-5).

360 Allyson Poulos et al., *Securities Fraud*, 50 AM. CRIM. L. REV. 1479, 1482 (2013); *see also* 17 C.F.R. § 240.10b-5

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ and device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

361 *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see also* 15 U.S.C. § 78j(b)

that use of the words "manipulative and deceptive" to modify "device or contrivance" in section 10(b) strongly suggests an element of scienter.[362] Such an outcome is unsurprising, and is consistent with one of the major components of the *Aaron* decision.[363] Recall, in *Aaron v. SEC*, the Supreme Court affirmed that the requirement to establish scienter to prevail on a 10b-5 action applies when the SEC is the plaintiff as well.[364] The holding also affirmed the analysis of the language of section 10(b), pointing out that "'manipulative,' 'deceptive,' and 'contrivance' clearly refer to knowing and intentional misconduct."[365] The Court added that the legislative history indicated an intention to include a scienter requirement.[366]

To establish liability for a violation under section 17(a)(1) of the Securities Act of 1933, a plaintiff must establish scienter.[367] Like any other plaintiff, the scienter requirement applies to the SEC as well.[368] In *Aaron*, the Supreme Court analyzed the statutory language "to employ any device, scheme, or artifice to defraud," and held that the legislature clearly intended for scienter to be an element of the offense.[369] Comparing the language of 17(a)(1) to the *Hochfelder* ruling regarding Rule 10b-5, the Court held that inclusion of the word "device" was indicative of a scienter requirement in 17(a)(1), just as the *Hochfelder* Court held it was for Rule 10b-5.[370]

The Supreme Court has contrasted the language in section 17(a)(1) and Rule 10b-5 that require scienter, to the language of section 17(a)(2) and (3) of the Securities Act of 1933 that do not.[371] The language of 17(a)(2), "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made,

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(2014), which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement (as defined in section 206b of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

362 *Hochfelder*, 425 U.S. at 197.

363 *See* Aaron v. SEC, 446 U.S. 680, 691 (1980).

364 *See id.*

365 *Id.* at 681.

366 *Id.* (citing SEC v. Capital Gains Res. Bureau, 375 U.S. 180 (1984)).

367 *Id.* at 696.

368 *Id.* at 701-02.

369 *Id.* at 696.

370 *Id.*

371 *Id.* at 697.

not misleading," does not indicate that intent to defraud is required.[372] The *making* of an untrue statement does not indicate intent; merely making the statement, with or without intent, violates the Rule.[373] Contrast the making of a statement with *employing* a device, scheme or artifice to defraud; employing indicates not only mere action, but also intention to defraud.[374] Taking calculated steps to defraud, versus making misleading statements that can be made knowingly or unknowingly, is the difference between the requirement to prove scienter or not.

Analysis of section 17(a)(3) yields similar results.[375] The *Aaron* Court looked at the end result, not the action leading to that result, to determine if scienter is an element to be proven for a violation.[376] Here the statute prohibits engagement "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[377] The Court held that deliberate dishonesty is not required, analogizing the language of the statute with similar language in section 206(2) of the Investment Advisors Act of 1940 that also did not require "deliberate dishonesty as a condition precedent to protecting investors."[378]

Rule 13b2-2 is worded such that the Supreme Court would likely hold that scienter is not a required element that the SEC must prove for a court to find a defendant civilly liable.[379] The language of 13b2-2 does not involve engaging in deceitful or scheming activity for a violation to occur.[380] One need not employ a "device" to violate 13b2-2.[381] Instead, like sections 17(a)(2) and (3), 13b2-2 seems to focus on the end result; that is to prevent the communication of misleading information or the omission of such information to auditors, subsequently misleading investors.[382]

The wording of Rule 13b2-2, such as (a)(1) and (c)(1)(i) (to "make or cause to be made a materially false or misleading statement to an accountant,")[383] and (a)(2) and (c)(1)(ii) ("[o]mit to state, or cause another person to omit to state . . .") are more analogous to the wording of 17(a)(2), which reads "to obtain money or property by means of any untrue

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372 *Id.* at 696.

373 *Id.* at 696.

374 *See id.*

375 *See id.* at 697.

376 *Id.*

377 *Id.* at 697 (citing section 17(a)(3)).

378 *Id.* at 697 (citing SEC v. Capital Gains Res. Bureau, 375 U.S. 180, 200 (1963)).

379 *See* Aaron v. SEC, 446 U.S. 680, 702 (1980).

380 *See generally* 17 C.F.R. § 240.13b2-2.

381 *See generally id.*

382 *See id.*; *see also* Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (to be codified at C.F.R. pt. 240), *available at* https://federalregister.gov/a/03-13095.

383 17 C.F.R. § 240.13b2-2(a)(1).

statement . . . ,"[384] and 17(a)(3), which reads "to engage in any transaction, practice or course of business which would operate as a fraud . . . ."[385] These rules are common in that they do not employ a scheme or artifice to defraud, nor do they use a device to defraud.

6. A Scienter Requirement is a High Hurdle to Overcome

Requiring the SEC to prove scienter in a Rule 13b2-2 civil enforcement action is akin to providing a negligence defense to defendants. Directors and officers have a fiduciary duty to provide accurate financial information to accountants and auditors.[386] By requiring the SEC to prove scienter when misleading information is given, defendants who, as a result of actual negligent behavior or as a result of intentional behavior disguised as simple negligence, become immune to SEC enforcement actions to remedy past or prevent future fraud.

The SEC is up against a powerful force—greed. Greed is a naturally motivating human instinct.[387] A driver for positive creativity, efficiency, and success, greed can also be dangerous if left unchecked, transforming from a positive motivator to a negative motivator to seek gains without regard to the consequences of others.[388] This negative motivator, combined with a scienter requirement, makes it worthwhile for one to misrepresent information for their personal or corporate gain, knowing full well that the ability of the SEC, as well as the private class action litigator, is limited and unlikely to succeed.

The Private Litigation Securities Reform Act of 1995 ("PLSRA") was designed to prevent abuses by class action *private* plaintiffs by requiring, among other things, increased specificity of the misleading information alleged, "pleading with particularity the facts giving rise to a strong inference of scienter," and a halt to discovery until the first two elements are met.[389] These requirements act as a hurdle to be jumped before their action can move forward.[390] Congress cited two primary purposes for enacting the PSLRA; to reduce abusive litigation, and to reduce coercive

384 15 U.S.C. § 77q(a)(2) (2011).

385 15 U.S.C. § 77q(a)(3) (2011).

386 *See* Pepper v. Litton, 308 U.S. 295, 310-11 (1939) (discussing generally the fiduciary duty of the directors and officers with respect to the corporation and its shareholders); *see also* RESTATEMENT (SECOND) OF TORTS §552 (2014).

387 *See* Ann Morales Olazabal & Patricia Sanchez Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scienter*, 60 FLA. L. REV. 401, 403 (2008).

388 *See id.* at 403.

389 Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path From Central Bank to Stoneridge Investment Partners*, 6 BERKELEY BUS. L.J. 131, 172 (2009).

390 *See generally id.* at 172-88.

settlements.[391] These purposes do not translate to the SEC, having no stake in the outcome except that of fulfilling their mission, which is to protect investors. In sum, a negligence standard would hold directors and officers to the professional standard required of their position, and allow the SEC to carry out their work of protecting the markets and the investing public.

7. The SEC Has Limited Resources to Carry Out Its Mission

The SEC, unlike other government agencies, is not self-funded; the agency does not receive the fines it imposes, it receives a budget annually from Congress.[392] Currently the SEC employs 4,200 employees, who monitor "more than 25,000 market participants, including broker-dealers, investment advisers, mutual funds and exchange traded funds, municipal advisors, clearing agents, transfer agents, and 18 exchanges."[393] In fact, the SEC budget has been cut recently, despite revenue produced from fines and penalties roughly doubling the prior year budget, and a twenty five percent budget increase proposed by the SEC Chair.[394] Decreased budgets and limited staffing, combined with new laws, are increasing the SEC workload, further limiting it from carrying out its mission.

The Commission's ability to properly enforce the rules and protect the investing public is limited.[395] Many incidents are not prosecuted due to limited SEC resources.[396] Requiring the Commission to prove scienter for a Rule 13b2-2 contributes to the strain of an already underfunded agency, and is contrary to the congressional intent both in creating the Commission, but also more importantly is contrary to the purpose of enacting section 303 of Sarbanes-Oxley.

8. Directors and Officers Can Be Protected for Good Faith Misstatements

Corporations can purchase insurance to protect directors and officers of the company from personal liability.[397] Known as "D&O Insurance," these policies can cover the cost of litigation, and financial liability for

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391 Kathryn B. McKenna, *Pleading Securities Fraud Using Confidential Sources Under the Private Securities Litigation Reform Act of 1995: It's All in the Details*, 55 RUTGERS L. REV. 205, 205 (2002).

392 *See* Rob Garver, *SEC Chief Says Agency is Badly Underfunded*, FISCAL TIMES 1-2 (Feb. 21, 2014), http://www.thefiscaltimes.com/Articles/2014/02/21/SEC-Chief-Says-Agency-Badly-Underfunded.

393 *Id.* at 1.

394 *Id.* at 1-2.

395 *See id.* at 2.

396 *See id.* at 1.

397 Lawrence J. Trautman & Kara Altenbaumer-Price, *D & O Insurance: A Primer*, 1 AM. U. BUS. L. REV. 337, 337 (2012).

losses, and even civil penalties if they are covered by the policy.[398] More importantly, while these policies protect against accusations of breach of fiduciary duty, they generally do *not* cover intentional fraud or violations of "statutes, rules, and regulations."[399] From a policy perspective, this is important; while the SEC has stated that good faith misstatements and omissions are not actionable, any claims brought would be covered by the policy for the cost of defense from the time the suit is initiated, unless the fraud provision applies.[400] The fraud provision of the policy incentivizes directors and officers to avoid intentionally disseminating fraudulent information or violating securities rules and laws by denying coverage if fraud is determined by a final adjudication.[401]

V. CONCLUSION

In the early 1940's, the president of a company in Boston was telling his shareholders that his company, which had quadrupled its earnings, was doing poorly, so that he could purchase the stock from them at deflated prices.[402] The SEC drafted a rule to forbid this type of fraudulent activity, which became Rule 10b-5, which was passed without comment or debate, save for one commissioner, Sumner Pike, who quipped, "Well, we are against fraud, aren't we?"[403] The question of whether the SEC should be required to prove scienter to enforce Rule 13b2-2 can be answered with that same rhetorical question.

Unfortunately, it is not that simple. But, fortunately, legal analysis and discussion of policy issues brings us to the same result. A look at the enabling statute shows that the language of Sarbanes-Oxley section 303(a) shows no intent to include a scienter requirement. The Rule, as written, does not require the SEC to prove scienter. The SEC is entitled to deference from the courts in their interpretation of any ambiguity in the Rule. The SEC interprets the Rule to not require scienter.

Case law analyzing SEC rules leads us to the same conclusion by comparing and contrasting cases. The Supreme Court's favorable decision in *Capital Gains* held that securities laws should be read broadly, enabling the SEC to prevent fraud. The *Hochfelder* Court required scienter, but can be distinguished because it was ruling on a private action. *Aaron* applied

398 *See generally id.* at 346-52.

399 *Id.* at 353.

400 *Id.* at 347-50.

401 *See id.* at 353.

402 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (citing Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW 793, 922 (1967)).

403 *Id.*

the analysis in *Hochfelder*, requiring scienter for SEC enforcement actions of section 17(a), and binding later courts to the decision, or forcing them to distinguish from *Aaron.*

Most importantly though are the analyses the Court used to arrive at these holdings, and the application of those analyses to Rule 13b2-2 to predict how the Court would rule. The broad interpretation in *Capital Gains*, the private enforcement specified in *Hochfelder*, and the similarity of Rule 13b2-2 to the analysis of sections 17(a)(2) and (3) in *Aaron,* all lead to the conclusion that, if the Supreme Court were to grant certiorari to decide whether the SEC is required to prove the element of scienter in an enforcement action, it would rule in the negative.

From a policy perspective, to require the SEC to prove scienter in a Rule 13b2-2 enforcement action is counter-intuitive. The SEC was created to enact and enforce rules to instill confidence in the financial markets and to protect investors. There is no pecuniary gain for the SEC in an enforcement action. Any action taken by the Commission is in the best interest of investors and the financial markets. To "tie its hands" by requiring it to prove the element of scienter in a 13b2-2 action is tantamount to providing a defense for any director or officer who misleads an auditor, except for the most egregious circumstances. A negligence standard holds directors and officers to a standard that the investing public expects and deserves.