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*By Norwood P. Beveridge**

INTRODUCTION

Criminal penalties for violation of the securities laws are provided at both the federal and state level.[1] At the federal level, most securities laws criminal proceedings[2] are brought for violations of the Securities Act of 1933 (1933 Act)[3] and the Securities Exchange Act of 1934 (1934 Act).[4] This Article will be limited to a discussion of the 1933 and 1934 Acts, although criminal provisions also are contained in other federal securities statutes.[5] In addition, while the same facts constituting violations of the 1933 and 1934 Acts may constitute violations of other federal criminal

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1. For an overview of the federal criminal provisions, see generally 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4684-716 (3d ed. 1993). For a discussion of state criminal provisions, see generally 12A JOSEPH C. LONG, BLUE SKY LAW ch. 8 (1996).

2. *See* MARVIN G. PICKHOLTZ, SECURITIES CRIMES 6-2 (1995). Criminal proceedings are brought by the Attorney General of the United States, who is given statutory authority to do so by § 20(b) of the Securities Act of 1933 (1933 Act), 15 U.S.C. § 77t(b) (1994), and § 21(d)(1) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78u(d)(1) (1994). The Securities and Exchange Commission (Commission or SEC) does not bring criminal proceedings, although it has authority to bring civil and administrative proceedings and to refer cases to the U.S. Attorney General for possible prosecution. *Id.*

3. 15 U.S.C. §§ 77a-77aa (1994 & West Supp. 1996).

4. *Id.* §§ 78a-78*ll*.

5. Criminal penalties are also provided in § 29 of the Public Utility Holding Company Act of 1935, *id.* § 79z-3 (1994), § 325 of the Trust Indenture Act of 1939, *id.* § 77yyy, § 49 of the Investment Company Act of 1940, *id.* § 80a-48, and § 217 of the Investment Advisers Act of 1940, *id.* § 80b-17. As to the latter two statutes, see Arthur F. Mathews, *Criminal Prosecutions Under the Investment Company Act of 1940 and the Investment Advisers Act*, 13 B.C. INDUS. & COM. L. REV. 1257 (1972).

statutes, such as the wire and mail fraud statutes, a discussion of those statutes is beyond the scope of this Article.[6]

Section 24 of the 1933 Act provides that any person who willfully violates its provisions, or the rules and regulations of the SEC thereunder, or who willfully makes a misstatement concerning a material fact or omits to state a required material fact in any registration statement filed under the 1933 Act, is guilty of a felony.[7] Section 32(a) of the 1934 Act provides that any person who willfully violates its provisions, or the prescriptive rules or regulations thereunder, or who willfully and knowingly makes any false or misleading material statement in any application, report, or document required to be filed under the 1934 Act, or under any rule or regulation thereunder, shall be guilty of a felony; however, if the violation is of a rule or regulation, the defendant can escape imprisonment (but not conviction or a fine) by proving a lack of knowledge of the rule or regulation.[8]

These two provisions have not been amended in any relevant way since their enactment, and numerous persons have been convicted and imprisoned under them. One would think, therefore, that the question of the degree of culpability required for a violation of the statutes would, by now,

6. Federal criminal prosecutors frequently join counts for violations of the securities laws with violations of the aiding and abetting statute, 18 U.S.C. § 2 (1994), the Racketeer Influenced and Corrupt Organizations Act, *id.* §§ 1961-68 (1994 & West Supp. 1996), the Money Laundering Control Act of 1986, as amended, *id.* §§ 1956-57 (1994), the general criminal conspiracy statute, *id.* § 371, mail fraud, *id.* § 1341, and wire fraud, *id.* § 1343, the false statements statute, *id.* § 1001, perjury, false statements, and subornation of perjury, *id.* §§ 1621-23, and obstruction of justice, *id.* §§ 1501-17; *see* PICKHOLTZ, *supra* note 2, at ch. 5.

7. Section 24, 15 U.S.C. § 77x (1994), reads as follows:

> Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.

8. Section 32(a), *id.* § 78ff(a), reads as follows:

> (a) Any person who willfully violates any provision of this chapter (other than section 78dd-1 [Sec. 30A, added by the Foreign Corrupt Practices Act of 1977] of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o [Sec. 15(d)] of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $1,000,000, or imprisoned not more than 10 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $2,500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

be well understood. That is not the case, however, and the state of the law has been described by one commentator as a "confusing state of affairs," "unsettled," and a "matter of great concern."[9]

The leading American commentator on the federal securities laws, Professor Louis Loss, has written for a half-century on the question, most recently with Dean Joel Seligman, without reaching any definite conclusion.[10] The first edition of Professor Loss's treatise was written while he was still Associate General Counsel to the Commission, and his thinking undoubtedly was influenced by the Commission's historical position that the word "willfully" in the statutes does not mean "with specific intent to violate the law."[11]

9. John P. James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securities Code*, 12 HARV. J. ON LEGIS. 1, 41, 61 (1974). The proposed Federal Securities Code would have discarded the use of the word "willfully" in favor of the terms "intentionally" or "recklessly." *Id.* at 44; *see also* AMERICAN LAW INST., FEDERAL SECURITIES CODE § 1821 (1981); Arthur F. Mathews, *A.L.I. Proposed Federal Securities Code: Part XV—Administration and Enforcement*, 30 VAND. L. REV. 465, 549-562 (1977). The Code was a 10-year (1968-1978) project of the American Law Institute, and in final form it comprises four bound volumes. The Code was never adopted, reaching what its Reporter, Professor Louis Loss, describes as its "legislative high water mark" in 1980. *See* 1 LOSS & SELIGMAN, *supra* note 1, at 283. Nevertheless, the Code has inspired, in areas other than the one under discussion, certain judicial, legislative, and administrative innovations. *See also* Samuel H. Gruenbaum & Marc I. Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A. L. REV. 247, 298 (1980) (stating that proof of specific intent not required); Arthur F. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 950 (1971) (noting that confusion persists concerning the meaning of "willfully" and "knowingly"); Arthur F. Mathews & William P. Sullivan, *Criminal Liability for Violations of the Federal Securities Laws: The National Commission's Proposed Federal Criminal Code, S. 1, and S. 1400*, 11 AM. CRIM. L. REV. 883, 890 n.26 (1973) (stating that consciousness of guilt not required); Jeffrey D. Berry, Note, *The Securities and Exchange Commission: An Introduction to the Enforcement of the Criminal Provisions of the Federal Securities Laws*, 17 AM. CRIM. L. REV. 121, 128 (1979) ("The precise meaning of . . . [the terms "willful" and "willful and knowing"] has eluded the courts."); Kim B. Stogner, Note, *Securities Regulation: Criminal Liability Under the Oklahoma Securities Act—The Willfulness Requirement*, 31 OKLA. L. REV. 486, 490 (1978) (noting that knowledge of illegality not required for federal violation); William E. Aiken, Jr., Annotation, *Element of Scienter As Affecting Criminal Prosecutions for Violation of Federal Securities Law*, 20 A.L.R. FED. 227, 234 (1974) (explaining that specific criminal intent not required for violations of certain prohibitory provisions of the Securities Act).

10. Professor Loss is now William Nelson Cromwell Professor Emeritus of the Harvard Law School. He was counsel to the SEC from 1937-1952, first as staff attorney, then as Chief Counsel, Division of Trading and Exchanges, then as Associate General Counsel. In 1952, he joined the Harvard Law School faculty, where he has remained. Dean Seligman was formerly a Professor at the University of Michigan Law School and is now Dean and Professor at the University of Arizona College of Law. *See* THE AALS DIRECTORY OF LAW TEACHERS 1995-96, at 624, 838 (1995).

11. Professor Loss represented the Commission in the well-known case of *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949), which held that, at least in an administrative disciplinary proceeding under § 15 of the 1934 Act, 15 U.S.C. § 78*o* (1994 & West Supp. 1996), the word "willfully" does not require proof of any intent to break the law. *Hughes*, 174 F.2d at 977.

In the 1951 first edition, Professor Loss tentatively suggested that "willfully" might require more culpability for a criminal conviction under section 24 than it does for broker-dealer discipline under section 15 of the 1934 Act, which provides civil penalties for a broker or dealer who "willfully" violates the securities acts.[12] He also suggested that "willfully" might require less culpability for a violation of the securities offering registration requirements under section 5 of the 1933 Act, which he described as *malum prohibitum*, than it does for violation of the antifraud provisions, which are *malum in se*.[13] In the end, he concluded that the question would have to be

The court also found, however, that the petitioner broker-dealer "intentionally and deliberately" continued her operations in spite of "repeated advice" from the Commission staff that her methods were unlawful. *Id.*

Sections 15(b)(4)(A) & (D) of the 1934 Act, 15 U.S.C. § 78*o*(b)(4)(A), (D), provide as follows:

> (b)(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated-
>
> (A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this chapter, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.
>
> (D) has willfully violated any provision of the Securities Act of 1933 [15 U.S.C. §§ 77a-77aa (1994 & West Supp. 1996)], the Investment Advisers Act of 1940, [15 U.S.C. §§ 80b-1 to -21 (1994 & West Supp. 1996)] the Investment Company Act of 1940 [15 U.S.C. §§ 80a-1 to -64 (1994 & West Supp. 1996)], the Commodity Exchange Act [7 U.S.C. §§ 1-25 (1994)], this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

The Commission's position with respect to broker-dealer discipline also has come under attack for reasons similar to those set forth in this Article. *See* Jonathan Eisenberg, *"Willful Violations" of the Federal Securities Law: Why the SEC's No-Fault Approach Is Now Ripe for Rejection*, 5 INSIGHTS, Aug. 1991, at 13.

12. LOUIS LOSS, SECURITIES REGULATION 734 (1951). Professor Loss went on to say, however, that the term "willfully" has been given "substantially the same construction" in both contexts. *Id.* at 734 n.91. See also *id.* at 735 n.94, in which Professor Loss cites the case of *United States v. Sussman*, 37 F. Supp. 294, 296 (E.D. Pa. 1941) (finding knowledge of illegality of sale of securities not required for violation of § 5).

13. *See* LOSS, *supra* note 12, at 734. In general, § 5 of the 1933 Act, 15 U.S.C. § 77e (1994), makes it unlawful to offer or sell a security through interstate commerce or the mails without compliance with the registration and prospectus delivery provisions of the Act. *See infra* note 79 for the text of § 5. The general antifraud provisions of the 1933 Act are found in § 17(a), 15 U.S.C. § 77q(a) (1994), which reads as follows:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of

settled by the U.S. Supreme Court,[14] something which has not yet happened.

Professor Loss took much the same position in the 1961 second edition of his treatise, where he concluded that "as nearly as one can say," in criminal cases under section 5 of the 1933 Act, the courts are more concerned with proof of knowledge of lack of registration than with evil motive or specific intent to violate the law.[15] The current third edition by Professors Loss and Seligman takes the same approach.[16]

Neither the 1933 Act nor the 1934 Act distinguishes between willful violations which consist of misrepresentations and fraud and other willful violations, such as failure to file a registration statement; both are felonies.[17] It is therefore, with respect, quite incomprehensible why a guilty mind and an unlawful intent must be shown to convict for misrepresentations,[18] but not for nonregistration, which may be quite innocent and harmless to investors.

It is the thesis of this Article that the terms of the statutes, the legislative history, and a fair reading of the cases compel the conclusion that criminal intent, or *mens rea*,[19] is required for conviction of all securities acts violations, whether fraudulent or nonfraudulent. It is further the thesis of this Article that the debate to date, which has focused on the meaning of the words "willfully" and "knowingly," has overlooked the more important

> any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

14. *See* LOSS, *supra* note 12, at 735-36.

15. LOUIS LOSS, SECURITIES REGULATION 1986 (2d ed. 1961 & Supp. 1969). This observation caused one federal district court to hold that insurance is available against "honest, though criminal, acts" in violation of the securities laws. Stargatt v. Avenell, 434 F. Supp. 234, 242 (D. Del. 1977).

16. 6 LOSS & SELIGMAN, *supra* note 1, at 3034-40; 10 LOSS & SELIGMAN, *supra* note 1, at 4684-93.

17. *See supra* notes 7-8 and accompanying text.

18. 10 LOSS & SELIGMAN, *supra* note 1, at 4690-93; PICKHOLTZ, *supra* note 2, § 6.11[1]; *see* United States v. English, 92 F.3d 909, 914-16 (9th Cir. 1996) (holding that jury instruction on willfulness is not required for conviction on § 17(a) violation).

19. *Actus non facit reum, nisi mens sit rea* (the intent and the act must both concur to constitute the crime). The term *mens rea* did not have a single meaning at the time of enactment of the 1933 and 1934 Acts. *See* Francis Bowes Sayre, Note, *Mens Rea*, 45 HARV. L. REV. 974, 988 (1932) (noting that the term has more than one meaning, but has generally been required for criminal conviction since the 13th century). It does not have a single meaning today; it is used in this Article to mean criminal intent, although not necessarily specific intent, to violate the securities laws.

consideration that criminal conviction for violation of the securities laws would require *mens rea* quite apart from the meaning given those terms.

THE LEGISLATIVE HISTORY

Professors Loss and Seligman have said that the legislative history of the SEC statutes is "not particularly helpful."[20] It is clear from the legislative history, however, that Congress intended that only intentional and not unwitting violations of the 1933 and 1934 Acts would be subject to criminal sanctions.[21]

THE SECURITIES ACT OF 1933

Although the 1933 Act has been described as "quintessential New Deal legislation,"[22] the origins of the penal provisions of the statute lie in the administration of President Woodrow Wilson. During World War I, the Capital Issues Committee was created under the Department of the Treasury.[23] The Committee was concerned, among other things, with the fleecing of the holders of U.S. Liberty Bonds by unscrupulous issuers who were persuading them to exchange their bonds for wildcat securities.[24] The fledgling Federal Trade Commission (FTC), created by the Federal Trade Commission Act of 1914,[25] was also pressed into service as the federal government's early enforcer against interstate securities fraud.[26]

President Wilson recommended passage of the Federal Securities Act proposed by the Capital Issues Committee in his message to Congress on August 8, 1919.[27] The bill, known as the Federal Stock Publicity Act, was introduced on May 19, 1919, by Rep. Edward T. Taylor and subsequently was known as the "Taylor bill."[28] The Taylor bill was not written by Rep. Taylor,[29] however, but by Bradley W. Palmer of Boston, Massachusetts,

20. 6 LOSS & SELIGMAN, *supra* note 1, at 3036 n.152.

21. *Id.*

22. LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 1 (3d ed. 1995).

23. *See* Huston Thompson, *Regulation of the Sale of Securities in Interstate Commerce*, 9 A.B.A. J., Jan. 1923, at 159.

24. *Id.* at 157. For a colorful account of this era, see Laylin K. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 625-30 (1934).

25. 15 U.S.C. §§ 41-58 (1994).

26. *See generally* Thompson, *supra* note 23.

27. *Federal Securities Act: Hearing on H.R. 4314 Before the House Comm. On Interstate and Foreign Commerce*, 73d Cong. 91, 103 (1933) [hereinafter *Federal Securities Act Hearing*], *reprinted in* 2 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973) [hereinafter LEGISLATIVE HISTORY]; *see* 1 LOSS & SELIGMAN, *supra* note 1, at 158-65.

28. *Proposed Federal "Blue-Sky" Law: Hearing on H.R. 188 Before the House Comm. on the Judiciary*, 66th Cong., 1st Sess. 3 (1919) [hereinafter *Blue Sky Hearing*] (statement of Rep. Edward T. Taylor of Colorado).

29. *Id.* at 7.

Counsel to the Capital Issues Committee.[30] The bill died in committee.[31] Based on internal evidence, the penal provisions of the Taylor bill, which were the origins of what was to become section 24 of the 1933 Act, undoubtedly were modeled after the penal provisions of the recently enacted Trading with the Enemy Act of 1917.[32]

The initial drafting of the bill which was to become the 1933 Act was given to Huston Thompson,[33] a lawyer in Washington, D.C., and a former member of the FTC, who had testified in favor of adoption of the Taylor bill in 1919.[34] His draft was introduced in both houses of Congress the same day as President Roosevelt's Message to Congress endorsing the legislation, March 29, 1933.[35] The penal provisions of the bill obviously were patterned after the Taylor bill, except that violation of the rules and

30. *Id.* at 19.

31. John Hanna & Edgar Turlington, *The Securities Act of 1933*, 7 S. CAL. L. REV. 18, 22 (1934).

32. The penal provisions of the Taylor bill were contained in § 15. See *Blue Sky Hearing*, *supra* note 28, at 7, which read as follows:

> Sec. 15. That whoever shall willfully violate any of the provisions of this act shall upon conviction be fined not more than $5,000, or if a natural person imprisoned not more than one year, or both, and the officer, director, or agent of any corporation who knowingly participates in such violation shall be punished by a like fine and imprisonment, or both.

The penal provisions of § 16 of the Trading with the Enemy Act, Pub. L. No. 65-91, 40 Stat. 411, 425 (1919), read as follows:

> Sec. 16. That whoever shall willfully violate any of the provisions of this Act or of any license, rule, or regulation issued thereunder, and whoever shall willfully violate, neglect, or refuse to comply with any order of the President issued in compliance with the provisions of this Act shall, upon conviction, be fined not more than $10,000, or, if a natural person, imprisoned for not more than ten years, or both; and the officer, director, or agent of any corporation who knowingly participates in such violation shall be punished by a like fine, imprisonment, or both, and any property, funds, securities, papers, or other articles or documents, or any vessel, together with her tackle, apparel, furniture, and equipment, concerned in such violation shall be forfeited to the United States.

This language, in the case of the Trading with the Enemy Act, has been held to require proof that a defendant acted with knowledge of the regulations and with specific intent to violate the act. *See* United States v. Macko, 994 F.2d 1526, 1530 (11th Cir. 1993); United States v. Tooker, 957 F.2d 1209, 1213-14 (5th Cir. 1992); United States v. Frade, 709 F.2d 1387, 1392 (11th Cir. 1983).

33. *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30-31 (1959).

34. *See Federal Securities Act Hearing*, *supra* note 27, at 25, *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 27 (statement of Hon. Huston Thompson, Commissioner, FTC).

35. The bill was introduced in the House by Rep. Rayburn as H.R. 4314 and referred to the House Interstate and Foreign Commerce Committee, of which he was Chairman, on March 29, 1933. *See* 3 LEGISLATIVE HISTORY, *supra* note 27, Item 22. It was introduced in the Senate by Sen. Robinson as S. 875 and referred to the Senate Judiciary Committee on March 29, 1933. On March 20, 1933, it was discharged from the Judiciary Committee and referred to the Banking and Currency Committee. *Id.* Item 28.

regulations of the Commission, as well as violation of the 1933 Act itself, also was made a felony.[36]

As recounted by James M. Landis, then a professor at the Harvard Law School, Rep. Sam Rayburn, Chairman of the House Interstate and Foreign Commerce Committee, was not satisfied with the Thompson bill.[37] The White House, therefore, turned to Professor, and later Justice, Felix Frankfurter, also on the Harvard faculty, who in turn conscripted Landis. Landis, together with Benjamin V. Cohen, a private securities practitioner, and Thomas G. Corcoran, Counsel to the Reconstruction Finance Corporation, completely redrafted the bill in Washington over the first weekend in April 1933.[38] The redrafted penal provisions followed the same format as the Thompson bill, except that a willful falsehood or omission in a registration statement also was made a felony.[39] The bill as enacted May 27, 1933, made a few clarifying changes in the penal provisions.[40]

In general terms, the 1933 Act provided that a violation of the registra-

36. Section 17 of H.R. 4314, H.R. 4314, 73d Cong. § 17 (1933), *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 27, Item 22, at 28, read as follows:

> Sec. 17. That whoever shall willfully violate any of the provisions of this Act, or the rules and regulations promulgated by the Commission pursuant thereto, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both; and any officer, director, or agent or any corporation who knowingly participates in such violation shall be punished by a like fine or imprisonment, or both.

37. *See* Landis, *supra* note 33, at 32-33. Professor Landis returned to Washington after the passage of the 1933 Act and was one of its first administrators. *Id.* at 29 n.*. He served from 1933-1934 as a Commissioner of the FTC, which administered the 1933 Act until the creation of the SEC in § 4 of the 1934 Act, 15 U.S.C. § 78d (1994); he then served as a Commissioner from 1934-1937 and as Chairman from 1935-1937 of the SEC. Landis, *supra* note 33, at 29 n.*.

38. *Id.* at 33-36.

39. Section 23 of H.R. 5480, introduced by Rep. Rayburn and referred to the House Interstate and Foreign Commerce Committee on May 3, 1933, read as follows:

> Sec. 23. Any person who willfully violates any of the provisions of this Act, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this Act, makes any untrue statement of a material fact or omits to state any material fact, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both.

H.R. 5480, 73d Cong. § 23, *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 27, Item 24.

40. Securities Act § 24, Pub. L. No. 73-22, 38 Stat. 74, 87 (1933), read as follows:

> Sec. 24. Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both.

According to Professor Landis, the added language was the work of Middleton Beaman, chief legislative draftsman for the U.S. House of Representatives. *See* Landis, *supra* note 33, at 36-38.

tion and prospectus provisions of section 5, or the antifraud provisions of section 17, would be subject to the power of the Commission to seek an injunction under section 20 and to civil remedies of buyers under section 12.[41] False statements in a registration statement would be subject to the Commission's power to issue refusal and stop orders under section 8 and civil remedies of buyers under section 11.[42] Only a person "willfully" violating section 5 or section 17 and "willfully" making false statements in a registration statement, however, would be subject to the criminal penalties of section 24.[43] A much-cited, early critical assessment of the statute concluded that criminal liability would result only from "intentional violations" and "in the clearest cases."[44]

THE SECURITIES EXCHANGE ACT OF 1934

Much has been written about the fact that the penalty provisions of the 1934 Act differ from those of the 1933 Act. In particular, while both penalize only a person who commits a violation "willfully," in the case of a material misstatement, the 1933 Act punishes an untrue statement "willfully" made, while the 1934 Act punishes a false or misleading statement "willfully and knowingly" made.[45] Professors Loss and Seligman write that it is "hard to say" what additional meaning to give the word "knowingly"

41. 15 U.S.C. §§ 77e, 77*l*, 77q, 77t (1994).

42. *Id.* §§ 77h, 77k.

43. House Interstate and Foreign Commerce Committee Chairman Sam Rayburn said in debate on the bill: "This bill makes absolutely responsible the issuer, the underwriter, and the dealer. It makes him responsible civilly if he sells stocks upon a misrepresentation; it makes him guilty of fraud and criminally liable if he sells it with misrepresentation and fraudulent intent." 77 CONG. REC. 2919 (1933). Section 17 (formerly § 13) originally had prohibited only violations "willfully" done; the fact that the word "willfully" was removed from § 17 was cited by the U.S. Supreme Court in holding that scienter is not necessarily required for a § 17 violation in an injunction action by the Commission. Aaron v. SEC, 446 U.S. 680, 698-701 (1980); *cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-93 n.40 (1963) (holding that in proceeding under the Investment Advisers Act of 1940 for the "mild prophylactic" of injunction, a lesser showing is required than for a suit for damages, a "willful" criminal violation, or a registration revocation).

44. William B. Herlands, *Criminal Law Aspects of the Securities Act of 1933, Part I*, 67 U.S. L. REV. 562, 566 (1933) [hereinafter Herlands, *Part I*]; *see* William B. Herlands, *Criminal Law Aspects of the Securities Act of 1933, Part II*, 67 U.S. L. REV. 615 (1933) [hereinafter Herlands, *Part II*]; *see also* Morris Jack Garden, Note, *Penal and Injunctive Provisions Of The Securities Act*, 23 WASH. U. L.Q. 251, 252 (1938) (stating that the obvious purpose of the Securities Act is to punish criminally only those in flagrant disregard of its provisions); *cf.* Note, *Legislation—The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1244 (1933) (noting that a possibility exists that no criminal intent will be required). For other contemporaneous treatments, see Malcolm A. MacIntyre, *Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes*, 43 YALE L.J. 254 (1933) (summarizing state, federal, and British statutes) and George E. Barnett, *The Securities Act of 1933 and the British Companies Act*, 13 HARVARD BUS. REV. 1 (1934) (comparing the 1933 Act with its British counterpart).

45. *See supra* notes 7-8.

in the 1934 Act,[46] and an early writer opined that the reason for the difference in language in the 1934 Act from the 1933 Act is "not perceived."[47]

The word "knowingly" was not in the 1934 bills as first introduced in Congress.[48] It was added following an interchange at the hearings before the House Interstate and Foreign Commerce Committee (House Committee) on February 20, 1934, between Thomas G. Corcoran, Counsel to the Reconstruction Finance Corporation,[49] and House Committee member Rep. George Huddleston. Mr. Corcoran stated that he thought the word "willfully" meant "knowingly," and because a question had been raised about that interpretation, the bill should be amended to make it clear.[50] The amended bill, introduced by Rep. Rayburn on March 19, 1934, introduced the word "knowingly" for the first time.[51] It remained

46. 10 LOSS & SELIGMAN, *supra* note 1, at 4691-93.

47. William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 184 (1934).

48. H.R. 7852, § 24, 73d Cong. (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 27, Item 24, was introduced by Rep. Rayburn and referred to the House Interstate and Foreign Commerce Committee on February 10, 1934. Its Senate counterpart, S. 2693, § 24, 73d Cong. (1934), *reprinted in* 11 LEGISLATIVE HISTORY, *supra* note 27, Item 34, was introduced by Sen. Fletcher and referred to the Senate Banking and Currency Committee on February 9, 1934. Both read as follows:

> Sec. 24. Any person who willfully violates any provision of this Act or any rule or regulation made thereunder, or any person who shall make, or any person, including a director, officer, accountant, or agent thereof who willfully is responsible for any statement in any application, report, or document filed with the Commission, which statement is, in the light of the circumstances under which it was made, false or misleading in any matter sufficiently important to influence the judgment of an average investor, shall upon conviction be fined not more than $25,000 or imprisoned not more than ten years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed.

49. It will be recalled that Mr. Corcoran was one of the draftsmen of the 1933 Act. *See supra* text accompanying notes 37-39.

50. *Stock Exchange Regulation: Hearing on H.R. 7852 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 113 (1934), *reprinted in* 8 LEGISLATIVE HISTORY, *supra* note 27:

> MR. HUDDLESTON. We are dealing with a criminal statute.
> MR. CORCORAN. Well, with respect to the criminal statutes, over on page 43, in section 24, there is a provision to the effect that the statute must be willfully violated.
> MR. HUDDLESTON. You do not think that that means knowingly, do you?
> MR. CORCORAN. Willfully.
> MR. HUDDLESTON. Yes.
> MR. CORCORAN. I should certainly think so, sir.
> MR. HUDDLESTON. Well, I am glad to have your point of view.
> MR. CORCORAN. I may be wrong.
> MR. HUDDLESTON. Willfully is more applicable to a civil liability than to a criminal liability. I submit that "willfully" does not necessarily mean "knowingly."
> MR. CORCORAN. Possibly, sir; the act needs redrafting on that point. May I go on?

51. H.R. 8720, introduced and referred to the House Interstate and Foreign Commerce

in the statute as enacted June 6, 1934.[52] Under the circumstances, no particular importance should be given to its inclusion in the statute except to make it clear that only false or misleading statements of material fact knowingly made are to be punished. It is true that section 24 of the 1933 Act could have been amended in 1934 to include "knowingly," but there are other illogical differences between the two statutes which have not been deemed significant.[53]

Another difference between the penal provisions of the two statutes is that, while both punish violations of related rules and regnlations as well as violations of the statutes, the 1934 Act allows a defendant to escape imprisonment if he proves he had no knowledge of the rule or regulation.[54] Again, this difference is not of any particular significance. The SEC's rulemaking authority under the 1933 Act allows it to make exemptions from the provisions of the statute and to issue interpretations of the statute.[55] In

Committee on March 19, 1934, provided as follows in § 25:

> Sec. 25. Any person who willfully violates any provision of this Act or any rule or regulation made thereunder, or any undertaking filed thereunder, or any person who willfully and knowingly makes, or any person, including a director, officer, accountant, or other expert thereof who willfully and knowingly is responsible for any statement in any application, report, or document required to be filed under this Act or any rule or regulation thereunder or in any communication, oral or otherwise, subject to the provisions of section 8(a) (5), which statement is, in the light of the circumstances under which it was made, false or misleading in any matter sufficiently important to influence the judgment of an average investor, shall upon conviction be fined not more than $25,000 or imprisoned not more than ten years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed.

H.R. 8720, 73d Cong. (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 27, Item 28.

52. Exchange Act § 32, Pub. L. No. 73-291, 48 Stat. 881, 904-05 (1934), read as follows:

> Sec. 32 Any person who willfully violates any provision of this title, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000 or imprisoned not more than two years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

53. For example, the definition of "security" in § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1994), is not the same as the definition in § 3(a)(10) of the 1934 Act, *id.* § 78c(a)(10). The U.S. Supreme Court has said that for practical purposes the two are "virtually identical." Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967); *cf.* United States v. Naftalin, 441 U.S. 768, 778-79 (1979) (finding rule of lenity requires that ambiguity in a penal statute such as § 17(a) of the 1933 Act should be resolved in favor of the defendant).

54. *See supra* note 52 (citing § 32 of the Exchange Act).

55. See § 3(b) of the 1933 Act, 15 U.S.C. § 77c(b) (1994), which gives the Commission authority to add to the statutory list of exempted securities other issues of securities where the aggregate public offering price is $5 million. The Commission has promulgated Regu-

general, persons are charged not with violations of rules and regulations under the 1933 Act, but with violations of the statute. By way of contrast, the Commission's rules under the 1934 Act are prohibitory and make certain acts unlawful by delegated authority under the 1934 Act to define crimes.[56]

The theoretical ability to escape imprisonment under section 32 of the 1934 Act has not proven to be of much practical use. In 1934, rules and regulations of the new administrative agencies were not yet subject to the Administrative Procedure Act,[57] which was adopted in 1946.[58] In 1934, there was a very real fear that agencies would issue rules and regulations of which no one would be aware, but would have the force of law.[59] In any event, section 32 has been interpreted so strictly that it would be virtually impossible to prove lack of knowledge of the substance of a particular rule.[60]

At the hearings before the Senate Committee on Banking and Currency on March 6, 1934, Ferdinand Pecora, counsel to the committee, stated clearly at several points that the bill was not intended to punish unwitting violations of the 1934 Act.[61] In several exchanges with witnesses, including particularly Howard Butcher, Jr., President of the Philadelphia Stock Exchange, Mr. Pecora stated that there was a "great difference" between a willful and an innocent violation of a penal statute.[62]

lation A, 17 C.F.R. §§ 230.251-.263 (1996), Rules 504 and 505 of Regulation D, *id.* §§ 230.504, 230.505, and Rule 701, *id.* § 230.701, under this authority. *See generally* 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION §§ 1.4, 4.15-4.19, at 15-21, 219-247 (3d ed. 1995).

56. See § 10 of the 1934 Act, 15 U.S.C. § 78j (1994), which makes it unlawful to effect short sales, or employ stop-loss orders or "any manipulative or deceptive deviee or contrivance" in contravention of rules and regulations to be prescribed by the Commission. The Commission in 1942 adopted its famous Rule 10b-5, 17 C.F.R. § 240.10b-5 (1996), under this provision. *See* 2 HAZEN, *supra* note 55, § 13.

57. Pub. L. No. 79-404, 60 Stat. 237 (1946).

58. *Id.*

59. *See* Erwin N. Griswold, Note, *Government in Ignorance of the Law—A Plea for Better Publication of Executive Legislation*, 48 HARV. L. REV. 198 (1934) (urging adoption of a scheme of publication of administrative rules and regulations).

60. *See* United States v. Lilley, 291 F. Supp. 989, 993 (S.D. Tex. 1968) (stating the defendants failed to prove lack of knowledge of the substance of Rule 10b-5); *cf.* United States v. Mandel, 296 F. Supp. 1038 (S.D.N.Y. 1969) (finding no violation of privilege against self-incrimination by requiring the defendant to prove lack of knowledge of Rule 10a-1(a)(2), 17 C.F.R. § 240.10a-1(a)(2) (1996), the short sale "downtick" rule).

61. *Stock Exchange Practices: Hearings on S. Res. 72 & S. Res. 73 Before the Senate Comm. on Banking and Currency*, 73d Cong. 6965-69, 7455-66, 7572-74, 7623-24 (1934), *reprinted in* 6 LEGISLATIVE HISTORY, *supra* note 27.

62. *Id.* at 7465. Mr. Pecora stated:

> MR. PECORA. Oh, no. It is not a technicality at all. It is a very substantial provision, and is intended to mean just what it says. There is a great difference between a willful violation of a penal statute and an innocent violation of it. Yes; there is all the difference

William B. Herlands, a federal prosecutor and later a federal judge, concluded in a contemporaneous article that "guilty intent" would be required for prosecutions under the 1934 Act.[63] It has been pointed out frequently that the U.S. Supreme Court had, just months before passage of the 1934 Act, held that when the word "willful" is used in a penal statute, it generally means an act done with a "bad purpose," not merely an act which is knowing, or voluntary, as distinguished from accidental.[64]

THE CASE LAW DEVELOPMENT

With this background, one might wonder why the issue of the degree of culpability required for a securities law criminal violation has remained in doubt. There are several reasons. First, the Commission took the position early that "willfully" in section 15 of the 1934 Act did not require proof of deliberate intention to break the law in a broker-dealer disciplinary proceeding.[65] This position apparently was upheld by the federal courts, notably in *Hughes v. SEC*.[66] Also, the criminal case law was slow to

in the world between the two.

Id.

63. *See* Herlands, *supra* note 47, at 147-48 (stating the word "willfully" in a penal statute means not merely "voluntarily," but with a "bad purpose"); *cf.* Herlands, *Part I*, *supra* note 44; Herlands, *Part II*, *supra* note 44.

64. *See* United States v. Murdock, 290 U.S. 389, 394, 398 (1933) (holding "willfully" as used in the Revenue Acts of 1926 and 1928 means not only voluntarily, but in bad faith or with evil intent).

65. *See In re* Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 854 n.21 (1959) (stating willful violation of § 5 of 1933 Act does not mean intentional violation); *In re* Ira Haupt & Co., 23 S.E.C. 589, 606 (1946) (holding sale of securities with knowledge of nonregistration is willful violation of § 5 of 1933 Act); *In re* Thompson Ross Sec. Co., 6 S.E.C. 1111, 1122-23 (1940) (finding violation of §§ 5 and 17 of 1933 Act willful, although based on advice of counsel); *supra* note 11 and aecompanying text. *But see In re* Lloyd, Miller & Co., 42 S.E.C. 73, 75 (1964) (finding no violation of § 5 of 1993 Act by salesmen who had no reason to know registration was required).

66. 174 F.2d 969, 977 (D.C. Cir. 1949); *see supra* note 11 and accompanying text. Of course, the Commission has consistently taken positions that would ease its enforcement burden. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (accepting SEC argument as *amicus* supporting implied cause of action in favor of public shareholders under § 14(a) of 1934 Act); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (accepting SEC argument as *amicus* supporting implied cause of action in favor of seller of securities under § 10(b) of 1934 Act and Rule 10b-5). The Commission has not been so successful in recent years. *See* Gustafson v. Alloyd Co., Inc., 115 S. Ct. 1061 (1995) (rejecting SEC position that 1933 Act § 12(2) remedies apply to nonpublic sales); Central Bank of Denver, N.A. v. First Interstate of Denver, N.A., 511 U.S. 164 (1994) (rejecting SEC argument that cause of action exists for aiding and abetting Rule 10b-5 violation); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (adopting short statute of limitations for Rule 10b-5 actions over SEC objections); Aaron v. SEC, 446 U.S. 680 (1980) (holding that SEC also must show scienter under § 10(b) of 1934 Act and § 17(a)(1), but not subsections (a)(2) or (a)(3), of 1933 Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (rejecting SEC argument as *amicus* that negligence is sufficient to support cause of action under § 10(b) of 1934 Act, and holding

develop, so in 1961, Professor Loss was able to say that the only case on point was *United States v. Sussman*.[67]

Another factor that clouded proper analysis was the appearance in 1956-1958 of the new Uniform Securities Act (Uniform Act).[68] Section 409, containing criminal penalties, used the word "willfully," and the Official Comment referred the reader to section 204(a)(2)(B), the broker-dealer disciplinary section, for its meaning.[69] The Official Comment to section 204 stated flatly that "[p]roof of evil motive or intent to violate the law, or knowledge that the law was being violated, is not required."[70] The only reference to the lack of well-reasoned criminal precedent was a comment in the Draftsmen's Commentary to section 409 that the word "willfully" "may conceivably be given a stricter interpretation in a criminal case."[71] The principal draftsman, of course, was Professor Loss. This has caused problems in interpretation at the state level which resemble the problems at the federal level.[72]

that scienter is required); Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996) (holding that SEC disciplinary proceeding is subject to five-year statute of limitations); Checkosky v. SEC, 23 F.3d 452 (D.C. Cir. 1994) (stating Commission needs to decide whether scienter is required for discipline of professionals under SEC Rule 2(e)); Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (finding Commission's attempt to regulate substantive voting rights of shareholders exceeds its statutory authority).

67. 37 F. Supp. 294, 296 (E.D. Pa. 1941); *see supra* notes 12-13 and accompanying text.

68. *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW (1958). The 1930 version of the Uniform Sale of Securities Act had been influential in the drafting of the 1933 Act, but the penal provision was not. Section 17 of the Uniform Sale of Securities Act (subsequently stricken from the list of approved uniform acts) read as follows:

> Section 17. *Penalty.* Whoever violates any provision of this act shall be punished by a fine of not more than [Five Thousand Dollars] or by imprisonment for not more than [three years], or by both such fine and imprisonment; but an affirmative showing that an act or omission which constituted a violation occurred in good faith and on reasonable grounds for believing it not to be a violation, shall relieve from the penalty prescribed in this section.

HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE THIRTY-NINTH ANNUAL CONFERENCE 173, 201 (1929). For an analysis of the 1930 Uniform Sale of Securities Act, see *Legislation, Uniform Sale of Securities Act*, 30 COLUM. L. REV. 1184, 1189 (1930).

69. "On the meaning of 'willfully,' see the comment under § 204(a)(2)(B)." UNIF. SEC. ACT § 409 cmt., 7B U.L.A. 631, 632 (1985).

70. *Id.* § 204 cmt., 7B U.L.A. 541, 545 (1985).

71. *See* LOSS & COWETT, *supra* note 68, at 388.

72. *See* People v. Simon, 886 P.2d 1271 (Cal. 1995) (holding the defendant has burden to raise reasonable doubt as to exemption; proof of scienter required for misrepresentation violation); People v. Corey, 41 Cal. Rptr. 2d 540 (Cal. Ct. App. 1995) (stating nonregistration is strict liability offense in California); People v. Terranova, 563 P.2d 363 (Colo. App. 1976) (noting nonregistration is strict liability offense); State v. Puckett, 634 P.2d 144 (Kan. Ct. App. 1981) (finding specific intent not required for nonregistration violation), *aff'd*, 640 P.2d 1198 (Kan. 1982); State v. Dumke, 901 S.W.2d 100 (Mo. Ct. App. 1995) (holding evil motive not required for nonregistration violation); State v. Jones, 453 N.W.2d 447 (Neb. 1990) (asserting

Sussman is, in any case, a very doubtful decision upon which to build a philosophy. The court's opinion on this point was rendered in a single sentence, without benefit of analysis or discussion of policy, legislative history, or precedent.[73] It hardly mattered to the defendants, a securities broker and the president of the issuer, who were charged with selling large blocks of the issuer's stock without registration, paying dividends out of capital, and sending false financial statements to investors.[74] They would have been convicted under any set of jury instructions and did not appeal.

A more interesting case was decided the same year by the U.S. Supreme Court.[75] The suit was brought by the assignee of an underwriter, based on an option to purchase 1.3 million shares of the defendant corporation's stock at ten cents per share. The option agreement, as later modified, also allowed the corporation to sell the shares to others at prices above ten cents per share and to remit the excess over ten cents to the optionee. The optionee had purchased and paid for 165,000 shares, and the issuer had sold many shares above ten cents, crediting the optionee with the excess over ten cents, amounting to $16,306.

The Supreme Court assumed the option agreement involved a public offering without registration in violation of section 5 of the 1933 Act.[76] The Court stated, however, that the option agreement "b[ore] no evidence of criminality and [wa]s fair upon its face."[77] Accordingly, the Court, with the blessing of the SEC appearing as *amicus*, held that the contract was not

specific intent not required for nonregistration violation); State v. Russell, 291 A.2d 583 (N.J. Super. Ct. App. Div. 1972) (holding criminal intent not required); State v. Bilbrey, 349 N.W.2d 1 (N.D. 1984) (stating evil intent not required for nonregistration violation); State v. Larsen, 865 P.2d 1355 (Utah 1993) (finding good faith no defense to fraud violation); 12A LONG, *supra* note 1, § 8.04[3], at 8-66 (asserting that meaning of willfulness is "the single most perplexing problem in connection with securities fraud prosecutions"); William R. Rapson, *Criminal Prosecutions Under The Colorado Securities Act*, 47 U. COLO. L. REV. 233, 241-42, 259-60 (1976) (arguing that securities violations in Colorado are strict liability offenses and should be reclassified as misdemeanors, not felonies); Mark A. Sargent, *Blue Sky Law*, 20 SEC. REG. L.J. 96, 101 (1992) (noting basis for assumption of no requirement of scienter for a willful violation "is by no means clear"); Richard M. Weinroth, *Overview of Civil and Criminal Liability of Clients and Attorneys for Federal and Arizona Securities Violations*, 26 ARIZ. ST. L.J. 1, 15 (1994) (stating nonregistration is strict liability offense; willfulness not required in Arizona). *But see* Hentzner v. State, 613 P.2d 821 (Alaska 1980) (asserting public welfare offense analysis is not proper; consciousness of wrongdoing is required for nonregistration violation).

73. In denying a motion for a new trial based in part on a failure to charge specific intent, the court said, "I did not then and do not now conceive an element of the crime charged in counts 15 to 21, inclusive [violations of Sec. 5 of the 1933 Act], to be actual knowledge that a security was being sold in violation of the law." United States v. Sussman, 37 F. Supp. 294, 296 (1941) (footnote omitted).

74. *Id.* at 295.

75. A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1941).

76. *Id.* at 40-41.

77. *Id.* at 42.

void and could be enforced.[78] It is apparent from this case that a contract in violation of section 5 is not *ipso facto* criminal in nature, even when the issuer and underwriter are aware that securities are being sold without registration.

SECURITIES ACT OF 1933 SECTION 5 VIOLATIONS

Section 5 is the heart of the 1933 Act, and by its terms prohibits all offers and sales of securities without complying with its registration and prospectus delivery requirements.[79] Yet the vast majority of securities offers and sales fall outside the operation of section 5 because of the exemptions provided in sections 3 and 4 of the 1933 Act.[80] Perversely, as a result of

78. *Id.* at 42-45; *see also* Judson v. Buckley, 130 F.2d 174 (2d Cir. 1942) (finding illegality of contract under 1933 Act no bar to recovery because no harm to public); *cf.* Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d Cir. 1952) (stating underwriting contract not enforced where registration statement is false and misleading).

79. Section 5, 15 U.S.C. § 77e (1994), reads as follows:

> *§. 77e. Prohibitions relating to interstate commerce and the mails.*
> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
>
> (b) It shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j [Section 10] of this title; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.
>
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h [Section 8] of this title.

Id.

80. *See* 1 HAZEN, *supra* note 55, § 2.2, at 86-87; 3 LOSS & SELIGMAN, *supra* note 1, at 1148 (stating exemptions probably cover more than 99% of all transactions in securities). The annual volume of trading of equity and options transactions alone (not including debt issues) on all national securities exchanges and the National Association of Securities Dealers Automated Quotation System (NASDAQ), *see* 2 HAZEN, *supra* note 55, § 10.3, at 53, was over

the highly technical nature of the 1933 Act and Commission regulations, an innocent violation of section 5 is not only quite possible but very common.[81] For the purposes of discussion, only violations not involving misrepresentation or fraud will be considered because it is conceded that fraudulent violations require proof of criminal intent.

Even nonwillful violations of section 5 already are subject to a punitive civil remedy in section 12(a)(1).[82] Under that section, a purchaser of securities is entitled to a free put of the securities back to the seller for one year after the violation, and no showing must be made of any damages to recover the amount of the purchase price plus interest.[83] Under section 15, this remedy also is available against controlling persons of the seller, such as controlling shareholders, officers, and directors, unless the controlling persons can establish an affirmative defense of lack of knowledge or reasonable grounds to believe in the violation.[84]

Is It a Security?

Because of the uncertainty surrounding the definition of "security" under the 1933 Act,[85] it is quite possible to sell a security without knowing

$4 trillion in 1993. U.S. SEC. & EXCH. COMM'N, 1994 ANNUAL REPORT 151-52 (1995). The total amount of all issues of securities, debt and equity, filed for registration under § 5 of the 1933 Act for 1993 was $868 billion, including $275 billion of common stock offerings. *Id.* at 53. Of course, this does not account for the immense amount of securities issued in exempt private placements under § 4(2) and Rule 506 of Regulation D, or under the small issue exemptions in § 4(6) and 3(b), Regulation A, and Rules 504 and 505 of Regulation D, nor the huge market in securities exempt under § 3, such as the government bond market, nor securities traded other than on an exchange or NASDAQ. See 2 HAZEN, *supra* note 55, § 10.1, at 1, for an overview of the securities markets.

81. *See* 2 HAZEN, *supra* note 55, § 2.2, at 87 (noting inattention or carelessness can easily lead to inadvertent violations of the prohibitions of § 5). There exists, in fact, a body of law surrounding the rescission offer which is a civil device designed to cure unwitting violations of § 5 by offering investors their money back. *See* 3 LOSS & SELIGMAN, *supra* note 1, at 1292-93; Michelle Rowe, *Rescission Offers Under Federal and State Securities Law*, 12 J. CORP. L. 383 (1987).

82. 15 U.S.C. § 77*l*(a)(1) (1994); *see* 1 HAZEN, *supra* note 55, § 7.2, at 370.

83. 15 U.S.C. § 77*l*(a)(1) (1994). The Supreme Court has held that in rare cases, an *in pari delicto* defense may be available. Pinter v. Dahl, 486 U.S. 622 (1988). Otherwise, the fact that the purchaser is a sophisticated investor is no defense. Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 1303 (2d Cir. 1977) (finding a market maker may claim protection of § 12(a)(1)).

84. 15 U.S.C. § 77*o* (1994); *see* 1 HAZEN, *supra* note 55, § 7.7, at 456.

85. The 1933 Act contains a definition of "security" in § 2(1), 15 U.S.C. § 77b(1) (1994):

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or,

it.[86] For example, the U.S. Supreme Court has held that, notwithstanding the specific exemption in the statute for insurance or annuity contracts issued by regulated insurance companies,[87] variable (as contrasted with fixed) annuity contracts are "securities" and must be registered for sale under section 5.[88] The Court has also held that a note is not necessarily a security,[89] a share of stock is not necessarily a security,[90] although it probably is,[91] and a fee interest in an orange grove in conjunction with a marketing agreement is a security.[92] It should be observed that none of the foregoing were criminal cases.

The Court noted early that the 1933 Act is both a penal and a remedial statute, resulting in two conflicting rules of construction: penal statutes are construed strictly and remedial statutes are construed liberally.[93] The Court held that when it is necessary to prove that a document is a security under the 1933 Act, proof must be by a preponderance of the evidence in a civil case and beyond a reasonable doubt in a criminal case.[94] Accordingly, it has been held that it is a question for the jury, not the court, whether a particular instrument is a security.[95]

in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, reeeipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

86. *See generally* 1 HAZEN, *supra* note 55, § 1.5, at 28.

87. Section 3(a)(8), 15 U.S.C. § 77c(a)(8) (1994).

88. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). James M. Landis, a principal draftsman of the 1933 Act, has said that the holding was quite correct. He added that if variable annuities had been a flourishing business in 1933, however, they undoubtedly also would have been exempted specifically due to the political power of the insurance industry. *See* Landis, *supra* note 33, at 46-47 n.24; *see also* SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) ("Flexible Fund" deferred annuity contract is security under 1933 Act).

89. Revcs v. Ernst & Young, 494 U.S. 56 (1990) (stating quality as security for purposes of 1934 Act depends upon investment characteristics).

90. United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975) (finding stock in cooperative housing project with appurtenant apartment lease not a security).

91. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (holding that sale of all outstanding stock is still sale of a security and rejecting "sale of business doctrine" that such a buyer is not an investor).

92. SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (holding such an interest to be an investment contract and therefore a security).

93. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353-55 (1943) (finding assignment of oil leases with associated drilling is investment contract and security).

94. *Id.* at 355.

95. D.H. Roe v. United States, 287 F.2d 435, 440 (5th Cir. 1961) (ruling that question of whether mineral leases were securities was for the jury). The same result is reached for § 17 violations of the 1933 Aet. United States v. Morse, 785 F.2d 771, 775 (9th Cir. 1986) (holding lack of objection to court determination bars review); United States v. Brown, 578 F.2d 1280 (9th Cir. 1978) (asserting no requirement to prove that the defendant knew a security was involved); United States v. Carman, 577 F.2d 556 (9th Cir. 1978) (finding evidence sufficient to support jury's determination); United States v. Austin, 462 F.2d 724, 737 (10th Cir. 1972) (ruling failure to submit question to jury harmless error under the circumstances); *see also* United States v. Gaudin, 115 S. Ct. 2310, 2313 (1995) (holding Fifth and Sixth Amendments

Is There an Exemption from Registration?

Most securities transactions are exempt from the provisions of section 5 under sections 3 and 4.[96] The U.S. Supreme Court has held, however, that an exemption is something for the defendant to raise, not for the prosecution to negate in the indictment.[97] Arguments that this shifting of the burden of proof, or at least of the burden of pleading and going forward, violates due process have not been successful so far.[98] The reasons for unavailability of the exemption may be quite technical, as when a private offering exemption under section 4(2) is defeated by an offering to a single unsophisticated person who does not purchase,[99] or when an intrastate exemption under section 3(a)(11) is defeated by a single offering to a nonstate resident who does not purchase.[100] Some cases have, for example, put the burden on the government to prove that a defendant broker knew he was selling for a controlling person, therefore eliminating the availability of the exemption under section 4(1).[101]

In a well-known case, an issuer and its president were convicted of criminal contempt for violating an injunction against sales of unregistered stock in violation of section 5.[102] The defendants were unable to sustain the burden of proving a section 4(2) exemption for a transaction not involving any public offering.[103] With respect to the requirement that the violation of the injunction be "willful," the court held that it would apply

of U.S. Constitution require that jury must find the defendant guilty of every element of crime charged beyond a reasonable doubt).

96. *See supra* text accompanying note 80.

97. Edwards v. United States, 312 U.S. 473 (1941) (holding indictment not demurrable for failure to allege lack of availability of exemption). The Supreme Court reiterated this placing of the burden on the issuer in a civil case in SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (finding burden on issuer to prove availability of private placement exemption of § 4(2)).

98. 3 LOSS & SELIGMAN, *supra* note 1, at 1145-49. The same arguments have been made under state Blue Sky laws. *See* Anthony J. DiPaula, Note, *Requiring Criminal Defendants To Prove Blue Sky Exemptions: A Question of Due Process*, 13 U. BALT. L. Rev. 612 (1984) (questioning constitutionality of majority rule putting burden of proof on the defendant).

99. *See* Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977) (holding sophisticated buyer may be entitled to rescission under § 12(a)(1) if another offeree nonbuyer was uninformed).

100. *See* 1 HAZEN, *supra* note 55, § 4.12, at 206; 3 LOSS & SELIGMAN, *supra* note 1, at 1292.

101. United States v. Re, 336 F.2d 306, 317 (2d Cir. 1964) (reversing conviction for failure to prove that shares sold were control shares).

102. United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967) (finding proof of specific intent to violate the injunction not required).

103. *Id.* at 678; *see also* United States v. Lindo, 18 F.3d 353 (6th Cir. 1994) (ruling no exemption available under §§ 4(1) or (2); the defendant not entitled to jury instruction on "good faith reliance on counsel" defense); United States v. Arutunoff, 1 F.3d 1112 (10th Cir. 1993) (asserting that the defendant was not entitled to jury instruction on defense of "good faith belief" in the availability of a private offering exemption when he did not request it during trial).

the same meaning given that word in prosecutions under section 24, namely that a specific intent to violate the law need not be proven.[104] Consequently, because the defendants already had been enjoined from violating the law and had repeated the "selfsame forbidden acts" knowingly, no more "explicit demonstration of an evil mind" would be required.[105]

Do Offering and Prospectus Violations Exist?

Even if scrupulous attention is given to preparing, filing, and causing to become effective a registration statement under the 1933 Act, it is still very easy to violate section 5. Section 5(c) prohibits all offers, whether oral or written, to sell securities prior to filing a registration statement.[106] Furthermore, because section 2(3) defines "offer" broadly as any attempt to generate interest in buying a security, not just a common law offer, any prefiling publicity about the issuer may amount to illegal "gun jumping."[107]

Even after filing the registration statement, with limited exceptions, only oral offers to sell can be made because a written offer is a "prospectus," as defined broadly in section 2(10), and section 5(b)(1) prohibits the use of such a prospectus unless it meets the requirements of section 10.[108] The limited exceptions include the preliminary or summary prospectus filed as part of the registration statement, which does meet the requirements of section 10(b), and the so-called "tombstone advertisement," which is excepted from the statutory definition in section 2(10) and is therefore not a prospectus.[109] An illegal written offer is a violation of section 5 which is not cured by a legal sale after the registration statement has become effective; hence, this gives rise to unavoidable section 12(a)(1) civil liability.[110]

In any event, no offer can be accepted until the registration statement not only has been filed, but becomes effective, because an accepted offer would be a sale, which section 5(a) prohibits until effectiveness.[111] After effectiveness, during the so-called "free writing period," written offers and

104. *Custer Channel Wing*, 376 F.2d at 681.

105. *Id.* at 682.

106. *See* 1 HAZEN, *supra* note 55, § 2.3, at 90-91. For that matter, offers to buy the securities also are unlawful prior to filing. *Id.*

107. *Id. See* SEC v. Thomas D. Kienlen Corp., 755 F. Supp. 936, 940 (D. Or. 1991); *In re* Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 851 (1959).

108. *See* 1 HAZEN, *supra* note 55, § 2.4, at 99.

109. *Id.* at 101. *See* Rule 134 for the post-filing tombstone ad (identifying statement), 17 C.F.R. § 230.134 (1996), and Rules 430 and 431 for the preliminary and summary prospectuses, *id.* §§ 230.430, 230.431.

110. *See* Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971) (finding broker's letter to his customer during the waiting period committing to sell 5000 shares of stock violates § 5 of the 1933 Act and is not cured by legal sale with delivery of a statutory prospectus after effectiveness).

111. *See* 1 HAZEN, *supra* note 55, § 2.5, at 105.

supplemental sales literature may be used, but only if accompanied or preceded by a statutory section 10(a) prospectus, because those writings are excluded from section 2(10)(a)'s definition of a "prospectus."[112]

Is an Illegal Secondary Offering Being Made?

This is a very fertile field for section 5 violations. Most secondary trading securities transactions effected on an exchange or over-the-counter will be exempt from section 5 by virtue of the combined exemptions in section 4.[113] Section 4(1) exempts a transaction by anyone other than an issuer, underwriter, or dealer;[114] section 4(3) exempts most transactions by a dealer which is not acting as an underwriter;[115] and section 4(4) exempts trading transactions by a broker acting pursuant to unsolicited customers' orders.[116]

The problem occurs with the broad definition of "underwriter" in section 2(11) of the 1933 Act.[117] An "underwriter" includes anyone who (i) purchases from an issuer with a view to distribution of a security; (ii) offers or sells for an issuer in connection with a distribution of a security; or (iii) participates directly or indirectly in such an undertaking, other than an ordinary broker's transaction.[118] The catch is that the term "issuer" for this purpose only includes controlling persons of the issuer.[119]

In a well-known case, a controlling shareholder sold through brokers over twenty-five percent of the outstanding stock of Continental Enterprises, Inc., owned by him and his associates.[120] The brokers' part in the transactions was exempt under section 4(4) because the brokers were unaware they were selling for a control person.[121] The court held, however, that the control person would have to find his own exemption, which he could not do under section 4(1) because his involvement made the brokers statutory underwriters selling for a control person treated as an "issuer" in section 2(11).[122] While the defendant testified that he was unaware registration was required,[123] the trial court instructed the jury that they must find he did know in order to convict, and the jury so found.[124]

112. *Id.* at 106.
113. *Id.* § 4.23, at 266; *see also* 15 U.S.C. § 77d (1994).
114. *Id.* at 267.
115. *Id.* at 266.
116. *Id.* at 268.
117. *Id.* § 4.24, at 270; *see also* 15 U.S.C. § 77b(11) (1994).
118. *See* 1 HAZEN, *supra* note 55, § 4.23, at 270.
119. *Id.* at 271.
120. United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968).
121. *Id.* at 782.
122. *Id.*
123. *Id.*
124. *See id.* at 786; Wolfson v. Baker, 623 F.2d 1074, 1079 & n.3, 1080 (5th Cir. 1980) (applying nonmutual collateral estoppel of criminal conviction to establish that Wolfson knew his sales were illegal); *see also* United States v. Rubinson, 543 F.2d 951, 959 (2d Cir. 1976) (finding no good faith defense was possible because the defendants had been warned that resale by control persons of stock distributed as a dividend was illegal).

In another case, the defendants were charged with reselling without registration over 290,000 shares of stock acquired by them from the issuer, making them underwriters under section 2(11).[125] The court held that it would be relevant to their willfulness to violate the law for the government to prove that the defendants must have known that their fraudulent scheme could not survive the disclosure required by registration.[126]

If brokers know that they are selling for a control person in an unregistered transaction, they also may be guilty of a criminal violation of section 5, unless an exemption can be found such as the safe harbor of Rule 144, the so-called "dribble out" rule that allows limited sales by control persons in certain carefully defined circumstances.[127] In one case, brokers were charged with selling unregistered stock for the account of the President of United Dye and Chemical Corporation.[128] They claimed they did not know the stock was required to be registered and had relied on an opinion of counsel.[129] Thc court affirmed the conviction of the defendants, upholding the trial court's charge that "[a]n act is wilful if it is done knowingly, deliberately and with an evil motive or purpose."[130] The case is particularly significant because the trial judge was William B. Herlands, author of the most influential articles on the criminal aspects of the securities laws and then a U.S. District Court judge for the Southern District of New York.[131]

Proof of Unlawful Intent in General

The courts also have held that proof that the defendants were making misstatements is relevant to their unlawful failure to register because the existence of a fraudulent scheme provided a reason not to register the

125. United States v. Abrams, 357 F.2d 539 (2d Cir. 1966).

126. *Id.* at 546.

127. *See* 1 HAZEN, *supra* note 55, § 4.26, at 285. Rule 144, 17 C.F.R. § 230.144 (1996), applies only to companies for which current public information is available. It allows sales by control persons in any three-month period, in ordinary brokers' transactions, when the shares sold in aggregate do not exceed the greater of one percent of the outstanding or the average weekly trading volume over the preceding four calendar weeks. *Id.*

128. United States v. Dardi, 330 F.2d 316 (2d Cir. 1964).

129. *Id.* at 331-32.

130. *Id.* at 331. The court stated that the defendants "must be shown to have known their actions were illegal even if they did not know exactly which statute they violated." *Id.* The court noted that Professor Loss was of the opinion that knowledge of illegality of sale was not required, but declined to consider the question under the circumstances. *Id.* at n.6. The court thus followed its precedent in *United States v. Crosby*, 294 F.2d 928 (2d Cir. 1961) (reversing conviction of brokers because guilty knowledge and criminal intent of § 5 violation was not proven in light of alleged reliance on advice of counsel); *see also* United States v. Robertson, 298 F.2d 739 (2d Cir. 1962) (finding charge as to criminal intent insufficient under *Crosby*).

131. *See supra* note 47 and accompanying text.

securities.[132] In another case, the court upheld an instruction that "[a]n act is done willfully if it is done knowingly and deliberately with bad purpose . . . [but] it is not necessary for the government to show that any defendant knew he was breaking any particular law."[133] Another court upheld a charge that "the word willfully means done deliberately and intentionally, with knowledge at the time that the conduct is an unlawful act."[134]

SECURITIES EXCHANGE ACT OF 1934 VIOLATIONS

If the 1933 Act is concerned with disclosure and fraud in connection with the offer and sale of securities, the 1934 Act is concerned with disclosure and fraud in connection with the trading of securities.[135] The 1934 Act requires the registration of all securities traded on a national securities exchange and all securities of issuers having more than $10 million in assets and a class of equity security with more than 500 shareholders.[136] It also requires the registration of all national securities exchanges, of which there are currently nine, securities associations (of which the National Association of Securities Dealers, Inc., currently is the only one), clearing agencies, transfer agents, and all nonexempt brokers and dealers.[137]

As with the 1933 Act, it is agreed that proof of *mens rea* is required for conviction of violations of the 1934 Act by misrepresentations and fraud.[138] With respect to nonfiling violations, a multitude of applications and reports

132. United States v. Schaefer, 299 F.2d 625, 630-31 (7th Cir. 1962) (holding good faith reliance on counsel not proven); *see also* United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964) (finding that lawyer, who knew that resales of stock issued prior to enactment of 1933 Act were not exempt under § 3(a)(1), had the required culpable state of mind).

133. Tarvestad v. United States, 418 F.2d 1043, 1047 (8th Cir. 1969) (ruling instructions adequately meet requirement for evil motive or guilty knowledge) (internal quotation marks omitted). The court also stated it was not "retreating from the dictum of" *Kistner v. United States*, 332 F.2d 978 (8th Cir. 1964), which has been cited for the proposition that knowledge of violation of law is not a necessary element of a § 5 violation. *Id.* at 981.

134. Roe v. United States, 316 F.2d 617, 621 n.9 (5th Cir. 1963). At the same time, the court stated that it was avoiding the necessity of deciding what "willfully" meant in the statute. *Id.* (internal quotation marks omitted).

135. *See* 1 HAZEN, *supra* note 55, § 9.1, at 513.

136. *Id.* § 9.2, at 514; 1934 Act §§ 12(b) & (g), 15 U.S.C. §§ 78*l*(b), 78*l*(g) (1994 & West Supp. 1996); Rule 12g-1, 17 C.F.R. § 240.12g-1 (1996).

137. *See* 2 HAZEN, *supra* note 55, §§ 10.2, 10.13, at 10, 134; 1934 Act §§ 6, 15(a), 15A, 17A, and 19(a)(1), 15 U.S.C. §§ 78f, 78*o*(a), 78*o*-3, 78q-1, 78s(a)(1) (1994).

138. *See* PICKHOLTZ, *supra* note 2, § 6.13[2]; *see also* United States v. Weiner, 578 F.2d 757, 784-85 (9th Cir. 1978) (finding accountants who certified financial statements of Equity Funding Corporation of America knew of the fraud and furthered it); United Statcs v. Natelli, 527 F.2d 311, 319-20 (2d Cir. 1975) (noting accountants who certified financial statements of National Student Marketing knew figures were materially false); United States v. Simon, 425 F.2d 796, 798 (2d Cir. 1969) (stating accountants who certified financial statements of Continental Vending must be shown to have had knowledge of falsity and intention to mislead in violation of 1934 Act § 32).

must be filed under the 1934 Act, such as annual, quarterly, and current reports and proxy statements required by sections 13 and 14 of issuers of securities registered under section 12 of the 1934 Act.[139]

In addition, for example, section 16(a) of the 1934 Act requires the filing of periodic stock ownership Forms 3, 4, and 5 by officers, directors, and more than ten percent beneficial owners of stock registered under section 12.[140] Over the years, this requirement met with a large and notorious measure of noncompliance.[141] Although criminal sanctions are available for a willful breach,[142] the Commission usually has relied on its enforcement powers and other means of persuasion.[143] In *United States v. Guterma*,[144] a criminal action filed for violation of section 16(a), Judge Friendly of the Second Circuit, writing for the court, upheld the interpretation of "willfully" as requiring some measure of criminal intent.[145] The court cited approvingly the 1934 article by Judge Herlands, where Herlands concluded that the term meant " 'not merely voluntarily but with a bad purpose,' " that is, with guilty intent.[146]

The difference in language between the 1933 and 1934 Acts' penal provisions, however, has given rise to a somewhat different interpretation of 1934 Act section 32(a). In *United States v. Peltz*,[147] a widely cited case in the Second Circuit, the defendant was charged with telling a broker to sell stock which he represented falsely that he owned. In making the sale, the broker unwittingly violated both the margin rules of the Federal Reserve Board and Rule 10a-1(a), the "downtick" rule, which prohibits a short sale at a price lower than the last reported price.[148]

139. *See* 1 HAZEN, *supra* note 55, § 9.3, at 520; 2 HAZEN, *supra* note 55, § 11.1, at 202. Section 13 (but not § 14) is also applicable by virtue of § 15(d), 15 U.S.C. § 78*o*(d) (1994), to issuers who have filed an effective registration statement for a public offering under the 1933 Act.

140. *See* 2 HAZEN, *supra* note 55, § 12.2, at 392.

141. *Id.* at 395.

142. *See* United States v. Guterma, 281 F.2d 742, 752 (2d Cir. 1960) (convicting the defendant of failure to file monthly reports under § 16); 2 HAZEN, *supra* note 55, § 12.2, at 392 n.3.

143. The Commission certainly knows the difference between an unwitting and a fraudulent failure to file a report under the 1934 Act. *Compare* Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) (holding nonwillful failure to file Schedule 13D will not support suit for injunction due to lack of irreparable injury) *with* SEC v. Bilzerian, 29 F.3d 689 (D.C. Cir. 1994) (applying collateral estoppel of criminal conviction to support $33 million civil disgorgement order) *and* United States v. Bilzerian, 926 F.2d 1285 (2d Cir. 1991) (finding willfully false statements on Schedule 13D constitute criminal violation).

144. 281 F.2d at 742.

145. *Id.* at 752-53.

146. *Id.* at 753 (citing Herlands, *supra* note 47, at 143-48 (internal quotations omitted)). Judge Herlands was, in 1960, a U.S. District Court Judge for the Southern District of New York and a neighbor of the renowned Judge Friendly.

147. 433 F.2d 48 (2d Cir. 1970).

148. *Id.* at 52-55. The defendant had thought he was in possession of materially unfavorable information with respect to the issuer. *Id.* at 50.

With Judge Friendly again writing for the court and again citing Judge Herlands' article, the opinion first stated that "[a] person can willfully violate an SEC rule even if he does not know of its existence." This follows because (i) unlike a misstatement, a violation of a rule need only be willful, not both willful and knowing; and (ii) section 32 states a defendant can violate a rule willfully and still escape imprisonment if he did not know of the rule.[149] The court also held, however, that the prosecution must establish the defendant knew what he was doing was an act "wrongful under the securities laws," and his act involved a "significant risk of effecting the violation that h[ad] occurred."[150]

In *United States v. Schwartz*,[151] a later Second Circuit case, the government charged the defendant with violation of 1934 Act section 8(c) and Rule 8c-1, which prohibit hypothecation by a broker-dealer of securities carried for the accounts of customers. This time, Judge Friendly was not on the panel. The court first rejected a good faith defense based upon an alleged conversation between the defendant and an SEC staff member.[152] The court then held that specific intent to violate the statute and the rule is not required.[153] As the district court had held, because the defendant admittedly knew of the existence and terms of the rule and statute, his private hope or belief that he was not in violation was no defense.[154] It was enough that he knew he was subjecting his customers to precisely the risk which the rule was designed to protect against.[155]

In reaching this decision, the court referred to the statute as a type of "public welfare offense," citing both *Sussman* and Professor Loss's treatise and rejecting Judge Herlands' conclusions.[156] This course in *Schwartz*,

149. *Id.* at 54-55.
150. *Id.* at 55.
151. 464 F.2d 499 (2d Cir. 1972).
152. *Id.* at 505.
153. *Id.* at 509.
154. *Id.*
155. *Id.*
156. *Id.* at 509-10. Public welfare offenses of course were known at the time of the enactment of the 1933 and 1934 Acts. *See* Francis Bowes Sayre, Note, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933). No criminal intent was necessary for conviction of such offenses. Examples cited by Professor Sayre were illegal sales of intoxicating liquor, sales of impure or adulterated food, sales of misbranded articles, violations of antinarcotic acts, criminal nuisances, violations of traffic regulations, violations of motor vehicle laws, and violations of general police regulations passed for the safety, health, or well-being of the community. *Id.* app. at 84-88. The *Schwartz* decision caused some confusion in the case of *United States v. Charnay*, 537 F.2d 341 (9th Cir. 1976). In *Charnay*, the majority of the panel cited Judge Herlands and *Peltz* to uphold an indictment for violation of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1994), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1996), in manipulating the price of a security in connection with a corporate takeover attempt. *Charnay*, 537 F.2d at 351-52. The indictment sufficiently charged commission of an act knowingly wrongful under the securities laws when it charged knowing participation in manipulation artificially depressing the market for a security. *Id.* A concurring opinion cited both *Schwartz* and Professor Loss's treatise for

however, was abandoned in *United States v. Dixon*,[157] a case involving violations of sections 13 and 14 in filing a false proxy statement and annual report on Form 10-K. Judge Friendly again wrote for the court and again cited Judge Herlands' article.[158] In *Dixon*, the court adhered to its decision in *Peltz* that "some evil purpose" must be shown on the part of the defendant, notwithstanding the holding in *Schwartz*.[159]

The Second Circuit repeated its holding that criminal intent is an essential element of the crime charged in violations of the securities laws in *United States v. Bilzerian*.[160] The case involved several counts for violations of sections 7, 10(b), 13(d), and 17, in a complex series of transactions involving attempted corporate takeovers. In another recent case involving falsification of financial statements, the Eighth Circuit held that willful blindness of the defendant in a securities fraud case is an adequate substitute for actual knowledge of the facts constituting the fraud; however, a showing of negligence or mistake would not be adequate.[161]

THE SUPREME COURT'S MENS REA *DECISIONS*

THE SUPREME COURT AND WILLFULNESS

At the time of the writing of the 1934 Act, the U.S. Supreme Court had just decided in *United States v. Murdock*[162] that "willfully," when used in a penal statute, means not only voluntarily, but in bad faith or with evil intent.[163] That was not, however, the last word on the meaning of "willfully," which, as one writer puts it, has been used "in American law as an elastic proxy for a host of mental states ranging from 'malicious' to 'not

the proposition that proof of evil motive was unnecessary for a public welfare offense. *Id.* at 355-57. In denying a petition for a rehearing, however, the court said that it certainly had intended to require proof of scienter, an intent to defraud or deceive, as mandated by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), for any violation of § 10(b), civil or criminal. *Id.* at 358. The indictment was later dismissed due to the government's inability to produce a key witness at trial. United States v. Charnay, 577 F.2d 81 (9th Cir. 1978).

157. 536 F.2d 1388 (2d Cir. 1976); *see also* United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986), *aff'd by evenly divided court*, 484 U.S. 19 (1987) (stating the defendants in § 10(b) insider trading violation "had adequate notice of the illegality of their acts"); United States v. Chiarella, 588 F.2d 1358, 1370-71 (2d Cir. 1978), *rev'd on other grounds*, 445 U.S. 222 (1980) (finding the defendant must engage in acts " 'knowingly wrongful' " under the securities laws for § 10(b) insider trading violation; specific intent to defraud not required).

158. *Dixon*, 536 F.2d at 1395-98.

159. *Id.* at 1397.

160. 926 F.2d 1285, 1293 (2d Cir. 1991).

161. United States v. Gruenberg, 989 F.2d 971, 974-75 (8th Cir. 1993). The defendants were charged with violations of §§ 6(f), 10(b) and 13(a) of the 1934 Act. 15 U.S.C. §§ 78f(f), 78j(b), 78m(a) (1994). The court stated that "[t]he element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him." *Gruenberg*, 989 F.2d at 974.

162. 290 U.S. 389 (1933).

163. *Id.* at 394-95.

accidental.' "[164] Thus, the Court in *United States v. Illinois Central R.R.*[165] held that "knowingly and willfully," in a statute prohibiting the carriage of cattle by rail for more than thirty-six hours without feeding and watering meant "purposely or obstinately," as by one who "either intentionally disregards the statute or is plainly indifferent to its requirements."[166]

In the case of federal tax laws, which were involved in *Murdock*, the Court subsequently held that "willful" nonpayment of tax, to constitute a criminal offense, must include "some element of evil motive and want of justification."[167] It later held that "willfully" filing a false return connotes both a "voluntary, intentional violation of a known legal duty" and a "bad purpose or evil motive,"[168] but in a subsequent case explained that no evil motive need exist apart from "a specific intent to violate the law."[169] Most recently, the Court has held that a willful evasion of tax is not proven if the defendant possessed a good faith belief that taxes were not payable on his income, even if his belief is not objectively reasonable.[170]

In another case, the Court held that a "willful" deprivation of constitutional privileges or immunities under color of state law means action not just with a general bad purpose, but with the specific bad purpose of depriving the individual of a constitutional right.[171] The Court has also held that a conviction for "willfully" structuring a cash transaction to evade a financial institution's reporting requirements for transactions involving more than $10,000 in cash requires a showing that the defendant knew his conduct was unlawful.[172] Congress in this case promptly responded by amending the statute to delete the word "willfully."[173]

THE SUPREME COURT AND CONSCIOUSNESS OF WRONGDOING

Quite apart from the meaning of the word "willfully," the Supreme Court has held that criminal intent is a necessary element of all crimes except those for which Congress consciously has established a strict liability regime. In the well-known case of *Morissette v. United States*,[174] the Court held that even if the statute is silent as to intent, a "knowing" conversion

164. William S. Laufer, *Culpability and the Sentencing of Corporations*, 71 NEB. L. REV. 1049, 1067 (1992).

165. 303 U.S. 239 (1938).

166. *Id.* at 243.

167. Spies v. United States, 317 U.S. 492, 498 (1943).

168. United States v. Bishop, 412 U.S. 346, 360-61 (1973).

169. United States v. Pomponio, 429 U.S. 10, 11 (1976).

170. Cheek v. United States, 498 U.S. 192, 202 (1991). The defendant was convicted at retrial. United States v. Cheek, 3 F.3d 1057 (7th Cir. 1993), *cert. denied*, 510 U.S. 1112 (1994).

171. Screws v. United States, 325 U.S. 91, 107 (1945).

172. Ratzlaf v. United States, 510 U.S. 135 (1994).

173. *See* 31 U.S.C. § 5324(c) (1994); *cf. id.* § 5322.

174. 342 U.S. 246 (1952).

of government property requires proof of criminal intent, which is not satisfied by proof that the defendant took the property without permission, even though he knew that it was on government land.[175] In so doing, the Court distinguished larceny, a crime under the common law,[176] from the class of public welfare offenses that violate "controls deemed essential to the social order as presently constituted,"[177] for which intent is not a factor.

In *United States v. United States Gypsum Co.*,[178] the Supreme Court had to decide whether a criminal violation of the Sherman Act[179] requires proof of criminal intent or whether intent may be presumed conclusively from the anticompetitive effect of the defendants' actions.[180] Citing *Morissette*, the Court held that intent is an essential element of a criminal antitrust offense and that the Sherman Act did not mandate a "regime of strict-liability criminal offenses."[181] Criminal intent may, therefore, not be presumed and must be established not only by proof of anticompetitive effects, but by proof that the defendants had knowledge that the proscribed effects were probable.[182] This decision is significant particularly because the Sher-

175. *Id.* at 276. The court stated that "[t]he contention that an injury can amount to a crime only when inflicted by intention is no provincial or transient notion." *Id.* at 250. *Morisette* and *United States v. Gypsum Co.*, 438 U.S. 422 (1978), were both cited in *Liparota v. United States*, 471 U.S. 419, 425-26 (1985), in support of the Court's decision that criminal conviction of a defendant for "knowingly" violating the federal food stamp act requires proof "that the defendant knew his conduct to be unauthorized by statute or regulations." *Id.* at 425. See also *United States v. X-Citement Video, Inc.*, 115 S. Ct. 464 (1994), in which the Court held that the Protection of Children Against Sexual Exploitation Act of 1977 was not a public welfare offense. *Id.* at 468-69. Accordingly, the prohibition against "knowingly" dealing in a visual depiction of "a minor engaging in sexually explicit conduct" required proof that the defendant knew both that the actress was underage and that the material was sexually explicit. *Id.* at 472 (Stevens, J., concurring). Unfortunately for the defendants, this holding overturned the decision of the court of appeals that the statute was unconstitutional for not requiring such knowledge. As a result, their convictions were reinstated. United States v. X-Citement Video, Inc., 77 F.3d 491 (9th Cir. 1996).

176. *Morissette,* 342 U.S. at 265.

177. *Id.* at 255-56. The Court referred to such cases as *United States v. Dotterweich*, 320 U.S. 277, 281 (1943) (finding violations of Federal Food, Drug, and Cosmetic Act do not require consciousness of wrongdoing), *United States v. Behrman*, 258 U.S. 280 (1922) (holding Federal Narcotics Act, does not require criminal intent), and *United States v. Balint*, 258 U.S. 250, 258-60 (1922) (ruling Federal Narcotics Act does not require criminal intent); *see also* United States v. International Minerals & Chem. Corp., 402 U.S. 558 (1971) (knowing shipment of sulfuric acid was made is "knowing" violation, which is not excused by ignorance of regulations).

178. 438 U.S. 422 (1978).

179. 15 U.S.C. §§ 1-7 (1994).

180. *Gypsum,* 438 U.S. at 434. The trial judge had charged the jury that if the effect of the actions was to fix prices, then the defendants were presumed " 'to have intended that result.' " *Id.*

181. *Id.* at 435-37.

182. *Id.* at 444-45; *see also* Posters 'N' Things, Ltd. v. United States, 114 S. Ct. 1747, 1753-54 (1994) (citing *Gypsum*, 438 U.S. at 444) (requiring prosecution to prove the defendant sold items which he knew were likely to be used with illegal drugs for violation of Mail Order Drug Paraphernalia Control Act); *cf.* Carella v. California, 491 U.S. 263, 268 (1989) (citing

man Act uses the same language to define civil and criminal violations, and it does not use the words "willfully" or "knowingly."[183]

In reaching this result, the Court noted that strict liability offenses are "generally disfavored"[184] and the behavior proscribed by the Sherman Act is "often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct."[185] The use of strict liability criminal sanctions "would be difficult to square with the generally accepted functions of the criminal law,"[186] and the severity of the sanctions provided in the Sherman Act makes the use of a strict liability approach inappropriate.[187]

This approach also was apparent in *Staples v. United States*,[188] in which the Court was concerned with possession of a machine gun in alleged violation of the National Firearms Act.[189] The statute itself was silent regarding the *mens rea* required for a violation,[190] but the Court held that this did "not necessarily suggest that Congress intended to dispense with a conventional *mens rea* element, which would require that the defendant know the facts that make his conduct illegal."[191] The Court rejected the argument that the statute was a public welfare offense, which the Court stated it had recognized only in "limited circumstances," typically when the statute regulated " 'deleterious devices or products or obnoxious waste materials.' "[192] The Court held accordingly that the government must

Gypsum, 438 U.S. at 446) (per curiam) (finding statutory presumptions of theft by fraud and embezzlement of vehicle unconstitutional because they invade the jury's fact-finding function).

183. At the time of the alleged violations (1960-1973), § 1 of the Sherman Act read, in relevant part, as follows:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal: . . . . Every person who shall make any contract or engage in any combination or conspiracy declared by sections 1 to 7 of this title to be illegal shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding fifty thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

15 U.S.C. § 1 (1970).

184. *Gypsum*, 438 U.S. at 438.

185. *Id.* at 441.

186. *Id.* at 442. Such sanctions "would be used, not to punish conscious and calculated wrongdoing at odds with statutory proscriptions, but instead simply to *regulate* business practices regardless of the intent with which they were undertaken." *Id.*

187. *Id.* at 442 n.18.

188. 114 S. Ct. 1793 (1994).

189. 26 U.S.C. §§ 5801-72 (1994).

190. *Staples*, 114 S. Ct. at 1797. 26 U.S.C. § 5861(d) (1994), provides as follows: "It shall be unlawful for any person . . . (d) to receive or possess a firearm which is not registered to him in the National Firearms Registration and Transfer Record."

191. *Staples*, 114 S. Ct. at 1797.

192. *Id.* at 1798-1804 (citations omitted).

prove beyond a reasonable doubt that the defendant "knew the weapon he possessed had the characteristics that brought it within the statutory definition of a machine gun."[193]

The cumulative impact of this line of Supreme Court cases sends a clear message regarding the question under consideration. Strict liability crimes are disfavored and will be recognized only when Congress has unmistakably created them, typically in a situation involving inherently dangerous materials or products. Otherwise, the traditional *mens rea* requirement must be met, and the guilty mind of the defendant must be proved beyond a reasonable doubt. This is particularly true when the statute provides for substantial penalties and the conduct proscribed is difficult to distinguish from normal and acceptable business practices.

CONCLUSION

The legislative intent behind the 1933 and 1934 Acts, as shown in the legislative history and as interpreted by contemporaneous writers, demonstrates a clear congressional mandate that the criminal penalties of the securities laws should be used to punish only knowingly wrongful conduct. In fact, that is how they have been used and there is no responsible case law authority for the proposition that the securities laws create a system of public welfare offenses.[194]

Congress placed the word "willfully" in the statutes to indicate that only a deliberate violation would be punished criminally. Even in the absence of that evidence, the statutes, like the antitrust laws, cover a great body of legitimate business activity, through which the line between accepted and proscribed behavior frequently is hard to draw. No one really has advocated that routine filing and prospectus delivery delinquencies be treated as felonies, but the statutes do not distinguish between one willful violation and another; all are felonies, unless the distinguishing characteristic be that of criminal intent.

193. *Id.* at 1795. On remand, the court of appeals instructed the district court to enter a judgment of acquittal, concluding that "no rational juror could find Mr. Staples guilty beyond a reasonable doubt of the offense charged." United States v. Staples, 30 F.3d 108 (10th Cir. 1994).

194. *United States v. Sussman*, 37 F. Supp. 294 (E.D. Pa. 1941), is undeserving of the attention lavished upon it, being an offhand holding in a case where nothing turned on it. *United States v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir. 1967), talks a no-fault philosophy, but punishes the clearest kind of deliberate violation. *United States v. Schwartz*, 464 F.2d 499 (2d Cir. 1972), was harmonized with *United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970), by the redoubtable Judge Friendly in *United States v. Dixon*, 536 F.2d 1388 (2d Cir. 1976), and has passed into judicial oblivion. The *Kistner* opinion on this point, Kistner v. United States, 332 F.2d 978 (8th Cir. 1964), has been described as dictum and not followed in its own circuit.