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LIABILITY UNDER SECTION 12(2) OF THE SECURITIES ACT OF 1933 FOR FRAUDULENT TRADING IN POSTDISTRIBUTION MARKETS

THERESÉ H. MAYNARD*

INTRODUCTION

Traditionally, section 12(2) of the Securities Act of 1933 (1933 Act) has extended a rescission cause of action to the defrauded buyer against her immediate seller. This concept of "privity" expressly limits the prospective class of defendants. Assuming that a plaintiff could establish all the elements of a section 12(2) cause of action, including this built-in privity requirement, a well-accepted body of case law developed that assumed a cause of action existed on behalf of the defrauded buyer against her "seller" in the context of distribution transactions, as well as secondary, postdistribution trading transactions.  

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* Professor of Law, Rains Fellow, Loyola Law School, Los Angeles, B.A., University of California, Irvine, 1978; J.D., UCLA, 1981. Copyright 1990. All rights reserved. The award of a Rains Fellowship from Loyola Law School provided valuable research support in the preparation of this Article. The author gratefully acknowledges the thoughtful comments of her colleagues, Ralph Blakeney, Jan Costello,Jennifer Shurtleff, and Kay Tate, on an earlier draft of this Article. The author also wishes to thank Thelma Terre for her invaluable assistance and the law firm of Urland, Morello, Dunn & Maynard, Santa Ana, California, for graciously extending use of its research library.

3. Section 12(2) is a rescission statute, seeking to effect a refund to the defrauded buyer in exchange for a return to the seller of the purchased security. See L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 1022-25 (1983).
4. Pinter v. Dahl, 486 U.S. 622, 641-55 (1988), now defines the scope of "seller," at least for purposes of § 12(1). See infra notes 45-59 and accompanying text (discussing the § 12 privity concept as the Supreme Court recently interpreted it).
5. See infra notes 14-127 and accompanying text (discussing the elements of § 12(2) cause of action).

In each of these opinions, the courts never questioned the availability of a § 12(2) cause of action for fraud in connection with the postdistribution trading transactions at issue. Moreover, Congress has not seen fit to repudiate this body of authority; presumably, Congress' silence indicates its implicit approval of the application of § 12(2) to postdistribution transactions. See Herman & MacLean v. Huddleston, 459 U.S. 375, 386 (1983).
Recently, however, a growing body of federal case law has denied a section 12(2) cause of action to the defrauded buyer in the context of a postdistribution trading transaction. These courts reason, in a strained and rather distorted reading of the statute, that the 1933 Act concerns itself exclusively with the distribution markets whereas the Securities Exchange Act of 1934 (1934 Act) focuses primarily on the trading markets. Based on this cursory


As this Article was being finalized for publication, the United States Court of Appeals for the Third Circuit handed down its decision in Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991). The Third Circuit, in reversing the district court's decision, concluded as a matter of law "that the language and the legislative history of section 12(2) demonstrate that Congress did not there intend to protect buyers in the aftermarket, and we hold that section 12(2) provides a remedy to buyers of securities only in initial distributions." Id. at 684 (emphasis added). In adopting this interpretation of § 12(2), the Third Circuit's reasoning essentially mirrors that of those district courts that have reached the same conclusion. The Third Circuit's reasoning therefore is subject to the same criticisms as set forth in Part II of this Article.


9. "Securities markets" is the broad term used to refer to both (i) the distribution market whereby issuers raise capital by selling securities to investors and (ii) the secondary markets which provide liquidity for these investors by providing an organized marketplace for the continuous trading of securities previously issued and outstanding. See generally H. BLOOMENTHAL, SECURITIES LAW HANDBOOK 28 (1989-90 ed.) (footnote omitted) ("Securities markets can conveniently be divided for exposition purposes into distribution markets and trading markets."); R. JENNINGS & H. MARSH, SECURITIES REGULATION 1 (6th ed. 1987) ("The broad term 'securities markets' encompasses both the
characterization of these two great and complex pieces of federal legislation, these courts have struck down the defrauded buyer's section 12(2) cause of action on the ground that the transaction at issue occurred in the postdistribution market. In so doing, many of these courts interpret the term "prospectus" as used in section 12(2) to reflect Congress' intent to limit recovery to those buyers who were defrauded during the course of a "public offering." This line of reasoning, however, fundamentally misapprehends congressional intent underlying section 12(2), as well as the purpose of the statute when construed as a whole.

This Article examines the fundamental weaknesses of the reasoning underlying these recent decisions and concludes that the section 12(2) cause of action is available to any defrauded buyer, whether in the course of a primary distribution or in the secondary trading markets, who can satisfy the procedural prerequisites of this express cause of action. Courts should use these procedural restrictions, including the important concept of privity,10 to define the availability and scope of this express cause of action, rather than to imply a limitation that Congress intended the 1933 Act to regulate only distribution transactions. The language of section 12(2) and its relationship to the other relevant provisions of the federal securities laws,11 as well as an examination of the legislative histories of both the 1933 Act as a whole and section 12(2) specifically, establish that a section 12(2) cause of action exists for the defrauded buyer in the secondary markets.12 The courts markets for distribution of securities into public hands and the markets for continuous trading in outstanding securities."). The secondary markets also are often referred to as the "trading markets" or "postdistribution markets."

10. Although Pinter v. Dahl, 486 U.S. 622 (1988), construed the concept of "seller" for purposes of § 12(1), most courts since Pinter have used this definition for purposes of defining the scope of § 12(2) liability. See Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988); Capri v. Murphy, 856 F.2d 478, 478 (2d Cir. 1988).


12. Recent Supreme Court decisions indicate that the starting point in any analysis involving interpretation of a provision of the federal securities laws is the language of the statute itself. See Landreth Timber Co. v. Landreth, 471 U.S. 631, 665 (1985); Ernst
therefore should not apply the section 12(2) remedy selectively by implying a "bright line" test that neither the statute nor its legislative history supports or even suggests.

Because the starting point of any analysis of the provisions of the federal securities laws is the language of the statute itself, Part I of this Article sets forth the elements of a section 12(2) cause of action and concludes with an analysis of several hypotheticals showing how defrauded buyers may satisfy the elements of section 12(2) in both distribution and trading market transactions. Part II examines the legislative history of the 1933 Act as a whole, and of section 12(2) specifically. Because the legislative history does not squarely resolve the instant issue, Part II also provides a contextual analysis of the provisions of section 12(2). The purpose of this contextual analysis is to discern congressional intent by looking at section 12(2)'s relationship to other provisions of the statute. Part II also examines the reasoning of those courts that have addressed the question of whether section 12(2) relief is available to the defrauded secondary market buyer. Part III concludes that, consistent with the underlying purpose of the statute, a section 12(2) cause of action is available to any defrauded buyer who otherwise satisfies the elements of a section 12(2) cause of action, including its built-in privity requirement.

I. ELEMENTS OF A SECTION 12(2) CAUSE OF ACTION

Except for the issue of who may be liable thereunder, there is a paucity of case authority interpreting the requirements of & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976). The Court also looks to the legislative history of the provision at issue, and of the statute as a whole, to ensure that the Court's interpretation effectuates, and is consistent with, underlying congressional intent. See Aaron v. SEC, 446 U.S. 680, 697-702 (1980); United States v. Naftalin, 441 U.S. 768, 774-77 (1979); Hochfelder, 425 U.S. at 201-06. Finally, the Supreme Court has recognized that the federal securities laws and, in particular, the 1933 and 1934 Acts "constitute interrelated components of the federal regulatory scheme governing transactions in securities... As [we] indicated in SEC v. National Securities, Inc., 'the interdependence of the various sections of the [federal] securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen.' " Id. at 206 (quoting SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969)); see also Herman & MacLean v. Huddleston, 459 U.S. 375, 387 (1983) (holding that an express remedy under the 1933 Act does not preclude a cause of action under the 1934 Act). The Court thus often employs a contextual analysis so as to give effect to each provision of the federal securities laws in a manner that is consistent with, and that does not undermine, the other aspects of the federal securities laws.

13. See supra note 7 (collecting citations to these cases).
section 12(2). Presumably, the arrested development of section 12(2) is attributable in large part to the rapid growth and ensuing popularity of the implied cause of action under section 10(b) and its rule 10b-5 of the 1934 Act. Many commentators predicted a renewed interest in the section 12(2) remedy following the Supreme Court's 1976 decision in *Ernst & Ernst v. Hochfelder,* wherein the Court concluded that scienter was a required element of the rule 10b-5 implied remedy. The ruling in *Hochfelder* was part of a line of decisions in which the Court seriously restricted the availability of a private action under section 10(b) and rule 10b-5. Section 12(2) relief has been pursued more vigorously since those decisions because, at least by comparison, section 12(2) "provides one of the most powerful but least appreciated weapons" at the plaintiffs' disposal.

The elements of an express cause of action under section 12(2) of the 1933 Act are evident from the language of the statute. Simply stated, the statute entitles the purchaser to rescission from her seller (or in the event that the purchaser no longer owns the security, to receive damages equivalent to rescission) if the purchaser can establish that (1) the seller used interstate commerce or the mails (2) to offer to sell or to sell a security to the purchaser (3) by means of a prospectus or oral communication (4) that misstated or omitted a material fact (5) of which the purchaser did not have knowledge, unless (6) the seller sustains the burden of proving that she did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

18. *Id.* at 205 (the plaintiff must show a mental state on the part of the defendant embracing the intent to deceive, defraud, or manipulate).
indicates that “section 12(2) on its face applies to the offer or sale of any security,” whether such purchase is made in the primary or secondary market.22

A. Use of the Instruments of Interstate Commerce or of the Mails

Section 12(2) specifically requires that the offer or sale be made “by the use of any means or instruments of transportation or communication in interstate commerce or of the mails.”23 Commentators once vigorously debated the significance of the use of the word “in,” rather than the word “of,” to precede “interstate commerce,” with some arguing that Congress may have intended the word “in” to create a more restrictive scope for section 12(2).24 The prevalent view, however, emphasizes a very flexible approach to this requirement.25

Although a dearth of reported cases under section 12(2) deal specifically with the jurisdictional issue of interstate commerce, commentators generally agree “that the misrepresentation itself need not have been made in interstate commerce; the jurisdictional requirement is satisfied if the mails or interstate commerce were utilized for any part of the transaction.”26 In deciding whether a plaintiff has satisfied this aspect, courts generally look to the entire transaction, not to its isolated parts.27

Most of the cases have focused on the use of the mails because generally that is easier for the plaintiff to prove. A growing body of decisional law, however, relies on use of the telephone to satisfy the jurisdictional prerequisites of section 12(2), with some courts arguing that a purely intrastate phone call will not suffice.28 Nevertheless, the “more common and better reasoned view is that any use, interstate or intrastate, of the telephone or tele-

22. O'Hara, supra note 16, at 928-29 n.18 (emphasis added).
24. See Kaminsky, supra note 16, at 240; see also R. JENNINGS & H. MARSH, supra note 9, at 1336-37 ("[T]he Eighth Circuit in a footnote seems to suggest that this difference in language may distinguish a section 12 action from a Rule 10b-5 action . . . ").
26. See id. (emphasis added).
27. See id. at 240 n.43 and the cases collected therein. Indeed, the author provides several interesting examples of just "how tangential the use of interstate commerce or the mails can be" and yet still satisfy § 12(2)'s jurisdictional prerequisites. Id. at 241-42.
graph in the transaction will suffice." The flexible interpretation of the jurisdictional requirements of section 12(2), as reflected in the case law, is entirely consistent with the Supreme Court's oft-repeated instruction that federal "securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'"

B. The Privity Requirement: Offer or Sale of a Security to the Purchaser

The plaintiff must show that she was a purchaser in an "offer or sale" of a security. Because the rescission remedy of section 12(2) is generally available only to purchasers, misleading offers not followed by purchases do not create liability under section 12(2).

The term "sale" is defined in section 2(3) of the 1933 Act. As the courts have interpreted it, this term now embraces many different types of transactions and is not limited strictly to a sale of goods. For example, the original issuance of securities, conventionally referred to as "a distribution transaction," clearly is a "sale" under this definition. Courts, however, have treated many transactions occurring in the secondary markets, including mergers, exchanges of stock, and pledges of stocks, as sales under this definition. Once again, general agreement exists that a broad interpretation of this term is consistent with the remedial policies underlying the 1933 Act. This interpretation of "sale"

29. See Kaminsky, supra note 16, at 243; see also R. Jennings & H. Marsh, supra note 9, at 1386-37, especially the cases collected at n.10.
31. See Kaminsky, supra note 16, at 253; 1 T. Hazen, THE LAW OF SECURITIES REGU-

LATION 314 (2d ed. 1990). An offeree who does not purchase therefore cannot recover under § 12(2), even though the seller lied to or deceived her through misrepresentations or omissions as part of the seller's solicitation of buying interest. Should such an offeree purchase, however, she would then have a cause of action for the deceptive "offer to sell" and could seek rescission of the purchase under § 12(2). See L. Loss, supra note 3, at 1025.
33. See supra note 9 (defining "distribution market").
is consistent with the view that defrauded buyers on the secondary markets may recover under section 12(2).

One of the most litigated aspects of section 12(2) has been the question of who may be sued. Courts generally confer seller status on the party who transfers title or other interest in the security for value. Many courts have consistently relied on this narrow interpretation of section 12(2) and have limited liability strictly to the immediate seller. Some lower courts, particularly the Fifth Circuit, however, have applied a "proximate cause-substantial factor" approach to expand the liability of nontransferor participants. Courts adopting this theory imposed section 12 liability not only on the actual transferor of the security, but also on any person "whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place." This broad definition of "seller" allowed plaintiffs to bring section 12(2) suits against a broad spectrum of "participants," including lawyers and accountants who assisted in the preparation of disclosure documents and other selling literature prepared for dissemination to prospective buyers.

of § 12(2) precludes its availability to secondary market transactions, assuming the defrauded buyers satisfy the other statutory requirements. Indeed, affording § 12(2) relief to defrauded buyers in the secondary market is likewise "consistent with the remedial policy" underlying the 1933 Act. See infra notes 186-206 and accompanying text.


Section 15 of the 1933 Act imposes secondary liability on a person who controls a party found liable under § 12. 15 U.S.C. § 77o (1988). Courts may use this concept of "control person liability" to expand the category of persons who may be held liable under § 12(b) beyond those in direct privity with the plaintiff. See 6 L. Loss, SECURITIES REGULATION 3840 (1969 Supp.); Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 CALIF. L. REV. 80, 80 n.4 (1981). Another basis for expanding the scope of potential § 12 defendants is to rely on secondary liability theories of aiding and abetting and conspiracy to reach collateral participants in a sale. See generally O'Hara, supra note 16, at 979-86; Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. PA. L. REV. 597, 620-45 (1972). These theories of secondary liability for § 12(2) violations lie outside the scope of this Article.

38. See Abrams, supra note 36, at 878, 887-94.


40. See 1 T. HAZEN, supra note 31, at 322-24, 325 nn.21-29 and the cases collected therein.
This growing line of cases produced widely divergent results depending on the court's specific definition of "seller."\(^4\) The expansive definition of "seller" evoked sharp criticism from commentators, who complained, among other things, that the courts' decisions were not consistent with the statutory language of section 12, nor with its legislative history.\(^4\) Finally, in June 1988, the Supreme Court decided *Pinter v. Dahl*\(^4\) and rejected the lower courts' expansive formulation of the privity requirement.\(^4\)

In *Pinter*, the Court construed the definition of "seller" for purposes of section 12(1) and carefully limited its opinion accordingly.\(^4\) Many of the cases that the Court discussed, however, were primarily section 12(2) cases. Moreover, the relevant language of both subsections is substantially identical, suggesting that the same definition of "seller" should apply to both. Indeed, both the Second and Fifth Circuits have recently held that the *Pinter* standard applies to section 12(2) claims.\(^4\)

\(^{41}\) One author described these judicial developments as follows:

Three different lines of authority emerge in these [cases expanding the concept of who may be a "seller"]). In defining the parameters of who may be primarily liable as a seller under section 12(2), some courts adopt a rather ambiguous test geared to a collateral party's participation in the events leading up to the sale in question. The Fifth Circuit has rejected this participation test as overly broad and has developed a proximate cause analysis. Under this theory only those collateral parties whose participation is a substantial factor in causing a transaction to take place may be liable as sellers under section 12(2). The Eighth Circuit has rejected the proximate cause analysis and developed a third approach. Stating that the Fifth Circuit's test fails to adequately implement the underlying policies of the Securities Act, the Eighth Circuit held in *Wasson v. SEC* that the pivotal consideration should be "whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings."

Each of these tests grapples with the problem of determining what relationship a collateral participant must bear to the sales transaction in order to justify imposing primary liability under section 12.


\(^{43}\) 486 U.S. 622 (1988). Pinter was an oil and gas producer and a registered securities broker/dealer. *Id.* at 625. He sold fractional undivided interests in oil and gas leases to Dahl, a real estate broker, who had previously invested in oil and gas ventures. *Id.* Dahl in turn "touted the properties," *id.*, to his family, friends, and other business associates. *Id.* at 625 n.1. Eleven of these persons invested in the venture and each paid $7,500 for the unregistered securities. *Id.* at 626. Dahl "assisted [them] in completing subscription agreement forms prepared by Pinter . . . [but] received no commission from Pinter when each of them invested in unregistered interests on the basis of Dahl's involvement." *Id.*

\(^{44}\) *Id.* at 647-54.

\(^{45}\) See *id.* at 642 n.20 (in which the Court expressly declined to rule on the standard to be used for § 12(2) purposes).

\(^{46}\) See Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1113-15 (5th Cir. 1988); H. BLOOMENTHAL, *supra* note 9, at 282-83.
In a seven-to-one decision, Justice Blackmun, writing for the Court, acknowledged that only a defendant "from" whom the plaintiff "purchased" the securities may be liable. Although section 12(1) liability clearly attaches to the owner who passes title or other interest in the security for value, the Court declined to read this language to mean that section 12(1) liability attaches exclusively to the owner from whom the plaintiff "purchased" the security. The Court recognized that a person "may offer or sell property without necessarily being the person who transfers title" and, in support of this point, cited section 2(3) of the 1933 Act, which defines the term "offer" to include the "solicitation of an offer to buy." Relying primarily on this language, the Court found that solicitation activity by individuals other than the actual owner can constitute the basis for section 12(1) liability because solicitation involves "an activity not inherently confined to the actual owner" of the security. Moreover,

[t]he solicitation of a buyer is perhaps the most critical stage of the selling transaction . . . . In addition, brokers and other solicitors are well positioned to control the flow of information to a potential purchaser, and, in fact, such persons are the participants in the selling transaction who most often disseminate material information to investors.

Consistent with lower court authority, the Supreme Court, however, was reluctant to impose liability for "mere gregariousness"; it stressed that "gratuitous advice, no matter how enthusiastic, is not actionable under section 12(1). If one is merely assisting the buyer it would be 'uncommon to say' that the securities were purchased from him or that he was soliciting." The Court therefore held that before classifying someone as a seller, the plaintiff must show that the defendant's activity "was motivated at least in part by a desire to further his own financial interests or those of the securities owner."

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47. Justice Stevens dissented and Justice Kennedy did not participate in the decision.
48. See Pinter, 486 U.S. at 643-44.
49. See id. at 644-45 (rejecting Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979)).
50. Id. at 642.
52. Pinter, 486 U.S. at 643.
53. Id. at 646.
54. H. BLOOMENTHAL, supra note 9, at 281.
55. Pinter, 486 U.S. at 647. The Court, however, was unable to determine whether the defendant in the case at bar was a seller under the standard adopted in its opinion.
liation, a defendant’s indirect involvement in the selling process should not give rise to section 12(1) liability.\textsuperscript{56}

In establishing this formulation, the Court relied heavily on section 12(1)’s relationship to other provisions of the 1933 Act, as well as to the underlying purpose of the 1933 Act as articulated by Congress.\textsuperscript{57} This decisional strategy in \textit{Pinter} strongly suggests that the correct approach to deciding whether to apply section 12(2) to fraudulent postdistribution trading is to look first to the precise language of section 12(2) and to interpret that language in light of other relevant provisions of the 1933 Act, including section 2, the definitional section. Thus, the reasoning of those courts that deny section 12(2) relief to the defrauded secondary market purchaser\textsuperscript{58} is fundamentally flawed because they fail to consider fully the statutory language of section 12(2) or the section 2 definitions of terms used in section 12(2).

The opinion in \textit{Pinter} casts further doubt on the reasoning of these courts because the standard of "seller" that the Court established focuses on the defendant’s relationship to the buyer rather than on the defendant’s relationship to the transaction.\textsuperscript{59}
The district court opinions denying section 12(2) relief, on the other hand, have focused on the nature of the transaction, that is, whether plaintiff’s purchase was part of a distribution transaction or a secondary market transaction, an approach that is inconsistent with the analytical approach adopted by the Court in \textit{Pinter}.

\begin{footnotesize}
\begin{enumerate}
\item According to the Court, the \textit{Pinter} case for a determination of whether the defendant urged the purchaser to complete the transaction to further either his own or the seller’s financial interests. \textit{Id.} at 655.
\item It is clear that someone whose involvement consists merely of preparation of the registration statement or offering materials will not be classified as a seller under section 12. An attorney’s participation in preparing the offering materials will not render him or her a section 12 seller. An accountant’s participation in the offering materials, without more, is equally insufficient to establish Section 12 liability. \ldots Many of the cases imposing liability on accountants, attorneys, and underwriters were decided prior to \textit{Pinter} v. \textit{Dahl} \ldots
\item "The soundest interpretation of the term ["purchase", as used in § 12] \ldots is as a correlative to both "sell" and "offer," at least to the extent that the latter entails active solicitation of an offer to buy." \textit{Pinter}, 486 U.S. at 645. "This [approach] is in accordance with the underlying policies of Section 12(1) to impose strict liability and provide an in terrorem remedy which encourages compliance with the registration provisions in order to promote full and fair disclosure." \textit{H. Bloomenthal}, \textit{supra} note 9, at 280.
\item See 1 T. \textit{HAZEN}, \textit{supra} note 31, at 324-25.
\end{enumerate}
\end{footnotesize}
C. By Means of a "Prospectus" or Oral Communication

The seller must have engaged in fraudulent conduct by means of a prospectus or oral communication to be liable under section 12(2). Oral communications that omit a material fact or that misrepresent a material fact give rise to liability under section 12(2). By including the term "prospectus," section 12(2) also takes aim at any "writing" used to misrepresent or mislead.

Consistent with the approach used by the Court in Pinter in construing the term "seller" in section 12, the starting point of the analysis under section 12(2) is to examine the statutory definition of the term "prospectus." As defined in section 2(10) of the 1933 Act, "prospectus" includes "any notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." Congress defined this term very broadly, so as to capture almost any written communication that can be said to "offer" a security for sale, no matter what form it may take.

As envisioned by Congress, the section 2(10) "prospectus" definition obviously includes the traditional offering circular prepared in connection with registered distribution transactions, as well as other, perhaps more unusual writings that market participants may use to solicit investor interest, such as research reports, letters, or sales brochures.

In addition to identifying the means by which the fraudulent conduct must occur, some defendants have used the section 12(2) phrase "by means of prospectus or oral communication" as the basis for alleging a reliance requirement as part of the plaintiff's case-in-chief. In one well-known section 12(2) case, Sanders v. John Nuveen & Co., the court concluded that this phrase simply

61. See id.; text accompanying note 21.
62. Id.
64. See L. Loss, supra note 3, at 119.
65. The traditional offering circular prepared for use in the context of registered distribution transactions is, in common parlance, the prospectus, which is filed with the SEC as Part I of the registration statement.
66. See, e.g., Diskin v. Lomasney & Co., 452 F.2d 871, 873 (2d Cir. 1971) (in which the issuer sent a letter along with the prospectus to investors, apparently in an effort to pique their interest).
68. 619 F.2d 1222.
required the plaintiff to show that the prospectus or writing involved in that case, a commercial paper report, contained misleading statements of material fact.\textsuperscript{69} The court therefore overruled the defendants' attempt to use this language to inject a reliance requirement into section 12(2).\textsuperscript{70} The defendants in that case had urged the court to permit only those investors who received the misleading report to bring a section 12(2) cause of action.\textsuperscript{71} The court rejected this position on the grounds that such a position would import into section 12(2) a reliance requirement in clear contravention of congressional intent to liberalize the common law rescission cause of action as part of its overall policy of enhancing investor protection.\textsuperscript{72} Several commentators have expressed similar views:

The theory is that section 12(2) is designed to put the burden of responsibility upon those who would induce public reliance in the securities markets, namely, the sellers of securities. To accomplish this policy, it is reasoned that the purchaser should be relieved of all proof of reliance, and consistent with this policy, the purchaser need not prove causation either.\textsuperscript{73}

\textbf{D. Misstatement or Omission of a "Material" Fact}

To recover under section 12(2), the purchaser must show that the seller misrepresented or omitted a "material fact" in a prospectus or oral communication.\textsuperscript{74} Today, the relevant test for materiality is whether "there is a substantial likelihood that a reasonable [investor] would consider it important in deciding" whether to purchase the security.\textsuperscript{75} Although this definition of

\textsuperscript{69} Id. at 1227.
\textsuperscript{70} Id.
\textsuperscript{71} Id. at 1225.
\textsuperscript{72} Id. at 1226.
\textsuperscript{73} Kaminsky, supra note 16, at 284-65 (footnotes omitted); accord L. Loss, supra note 3, at 1024-25.
\textsuperscript{74} See text accompanying note 21.
\textsuperscript{75} TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). Although the Court originally formulated this definition in the context of a rule 14a-9 implied cause of action for violations of the proxy solicitation rules, courts have generally followed it in interpreting the concept of "materiality" under other provisions of the federal securities laws. See Alton Box Bd. Co. v. Goldman, Sachs & Co., 560 F.2d 916, 919-20 (6th Cir. 1977) (applying TSC standard of materiality to § 12(2) suit); L. Loss, supra note 3, at 550 (the TSC Industries "definition of 'material' has been followed (mutatis mutandis) in other SEC contexts"); see also Rule 405, 17 C.F.R. § 230.405 (defining "materiality" under the 1933 Act as "those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security").
"materiality" may suggest a showing of some form of causation, it does not require a showing of actual causation. Consequently, the only causation requirement that is part of the plaintiff's burden under section 12(2) is the element of reliance, or causation, that "is inherent in the concept of materiality." Moreover, the plaintiff need prove only one material misrepresentation or omission to recover; the plaintiff is not required to prove all of the misrepresentations or omissions that she may plead in her complaint. Finally, the question of materiality is a fact question for the jury to resolve. In certain situations, however, materiality may be so obvious that the court can resolve the issue as a matter of law.

E. Lack of Knowledge by the Purchaser

The only duty that section 12(2) imposes on the plaintiff as part of her case-in-chief is to show that, as of the time of sale, she did not know of the alleged misrepresentations or omissions. The section 12(2) cause of action places no duty of investigation on the purchaser; the duty to investigate, if any, falls exclusively on the seller. Accordingly, the section 12(2) plaintiff need not

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76. See Kaminsky, supra note 16, at 258.
77. L. Loss, supra note 3, at 1024; see also Kaminsky, supra note 16 at 258 (the reliance requirement is an objective standard of the "reasonable" investor). The Court of Appeals for the Seventh Circuit made this conclusion explicit in Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), cert. denied, 450 U.S. 1005 (1981), wherein the court held that plaintiffs in an action based on § 12(2) do not have to establish reliance. Id. at 1225. Plaintiffs do not necessarily have to establish, therefore, that they received or read the defective writings (in Sanders, the commercial paper reports). Id. Moreover, the Seventh Circuit in Sanders also held it sufficient that a prospectus containing misleading statements was distributed to some of the purchasers. Id. at 1227. To require, as defendant argued, that only those who received the report could recover under § 12(2) would, in effect, require reliance. Id. at 1225-26.
78. Id. In this regard, one should also note that the plaintiff must prove that the seller misrepresented or omitted a material "fact." In deciding whether a disputed piece of information is a fact, courts frequently distinguish between "hard" facts, "meaning statements concerning objectively verifiable historical events or situations," and "soft information," which generally includes "forward looking statements such as projections, predictions and statements concerning future expectations." New Approaches to Disclosure in Registered Security Offerings—A Panel Discussion, 28 BUS. LAW. 505, 506 (1973) (remarks of Carl Schneider); see also 1 T. Hazen, supra note 31, at 317 ("Broadly generalized opinions may not be actionable under section 12(2) to the extent that a certain amount of puffery is permissible." Soft information thus must be further distinguished from "mere puffery.").
79. See Kaminsky, supra note 16, at 266.
80. See Kaminsky, supra note 16, at 266.
81. See, e.g., Sanders, 619 F.2d at 1224; Kaminsky, supra note 16, at 266.
prove that she could not have learned the true facts had she exercised reasonable diligence prior to purchasing.  

As one court suggested, "Availability elsewhere of truthful information cannot excuse untruths or misleading omissions" by the seller. Courts, therefore, generally reject any defense based upon common law concepts of the purchaser/plaintiff's "contributory negligence" or "assumption of risk." The only available defense under section 12(2) based on the conduct of the purchaser is that the purchaser was aware of the misstated or omitted fact. Similarly, the claim that the plaintiff is a sophisticated investor will not bar recovery and does not lessen the duty of disclosure that the seller/defendant owes to the purchaser. "A

82. In this respect, § 12(2), a modified rescission cause of action, may be more advantageous to the plaintiff/purchaser than a rule 10b-5 fraud cause of action. See Kaminsky, supra note 16, at 266-67. Courts may deem the rule 10b-5 plaintiff to have "constructive" knowledge based upon facts that were readily available to him. To avoid a finding of constructive knowledge, many courts require the rule 10b-5 plaintiff to show that she used reasonable diligence to learn the material facts. See id. at 267 nn.167-68 and cases cited therein.

83. Dale v. Rosenfeld, 229 F.2d 885, 858 (2d Cir. 1956).


85. Whether and to what extent the purchaser will be deemed to know allegedly "public" information remains an open question under § 12(2). Many rule 10b-5 cases have held that the defendant need not disclose facts which he reasonably believes the plaintiff already knows, specifically including those which are publicly available, but the defendant must have had reasonable grounds for believing that disclosure from him was unnecessary. Kaminsky, supra note 16, at 272 (footnotes omitted).

Any attempt to impute a constructive knowledge component in a § 12(2) action, however, may be inconsistent with Congress' apparent intent that § 12(2) shift the duty of investigation to the seller to encourage the seller to make full disclosure. Id. at 273. On the other hand,

a plaintiff may fairly be deemed to know some broadly publicized facts based upon the extent of their publication and the purchaser's own habits of investigation, such as reading periodicals or newspapers, or listening to the radio or watching television. But the burden should be placed decidedly on the defendant to show both that the purchaser had easy and ready access to the precise information and that the seller knew or had very good reason to believe that the purchaser was actually looking into the matter or would learn of such information on his own. Id. (footnote omitted); see also Value Line Fund, Inc. v. Marcus, [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965). In any event, the public availability of the information need not be part of the plaintiff's case-in-chief, but should be part of the seller's burden. To do otherwise would be to contravene the shifting of the burden of proof that Congress set forth in § 12(2). See infra notes 88-101 and accompanying text discussing seller's affirmative defense of reasonable care.

seller cannot cheat a person merely because he or she is rich and intelligent."\(^8\)

**F. Seller's Lack of Knowledge and "Reasonable Care"**

The only affirmative defense available to the seller in a section 12(2) suit requires the seller to prove not only that she did not know about the untruth or omissions, but also that she could not have learned the truth by the exercise of reasonable care.\(^8\) The fact that the defendant may have acted honestly and in good faith is irrelevant if, with reasonable diligence, the seller could have discovered the truth.\(^9\) Thus, the crucial issue to be resolved in establishing this affirmative defense is to define the scope of the seller's reasonable diligence burden. The leading case addressing this question under section 12(2) is *Sanders v. John Nuveen & Co.*\(^9\)

In *Sanders*, the defendant acted as an underwriter of commercial paper for a finance company, which the defendant placed in exempt transactions with forty-two purchasers.\(^9\) With the cooperation of its auditors, the issuer of the commercial paper had engaged in a deliberate fraud by overstating its receivables by

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88. This involves proving not only a negative fact, but also a negative hypothetical possibility, a decidedly difficult task.

The seller's task is difficult but not impossible. In many respects the seller's task of proving that he did not know is similar to that which the purchaser bears under § 12(2). There is, however, one significant difference: there appears to be no reason not to impute constructive knowledge to the seller. Indeed, he is deemed to know anything he could readily have learned. Proving that he could not have known, had he exercised reasonable diligence, is even more difficult. In that regard, what constitutes "reasonable diligence" would appear to be determined by reference to the common law meaning of that term.

*Id.* at 275.

89. See *id.* at 277. In addition to the § 12(2) affirmative defense of "reasonable care," a short statute of limitations applies to § 12(2) actions. See Securities Act of 1933, § 15, 15 U.S.C. § 77m (1988). The seller also may try to establish that the purchaser actually knew the misrepresented or omitted facts or that the facts were not material. Additionally, the defendant could attack certain jurisdictional prerequisites, such as whether the instrument purchased was a "security" or whether the facilities of interstate commerce or the mails were used as part of the transaction at issue.

Other defenses may be available to the seller, including waiver and estoppel. Courts, however, must be vigilant so that these defenses do not improperly negate the prudent rule that contributory negligence and assumption of the risk are not defenses under § 12(2). See Kaminsky, *supra* note 16, at 279.

90. 619 F.2d 1222.
91. *Id.* at 1224.
approximately $14 million and understating its indebtedness by approximately $1.7 million.92 The defendant/underwriter, unaware of the issuer’s fraud, distributed misleading “commercial paper reports” based on the issuer’s data to some purchasers and made misleading oral statements to other purchasers.93 A large number of the purchasers, however, had neither received nor read the reports, and the broker/dealer firm had made no specific representation to them.94

The United States Court of Appeals for the Seventh Circuit found the defendant/underwriter firm liable.95 In so ruling, the court turned to section 11 of the 1933 Act to help define the scope of “reasonable care” under section 12(2).96 The two sections, however, appear to set out different standards. Section 12(2) imposes liability on a defendant who fails to establish that she used “reasonable care,” whereas section 11 expressly requires certain defendants, as part of the due diligence defense, to prove they made a “reasonable investigation.”97 Despite these differences in statutory language, the Seventh Circuit decided that section 12(2) did not differ from section 11 with respect to the defense of an underwriter.98 In emphasizing the underwriter’s role, the Seventh Circuit decided that such a seller must make a reasonable investigation to establish that she used reasonable care for purposes of her section 12(2) defense.99 With respect to other types of sellers sued under section 12(2), “a reasonable investigation may or may not be necessary in order to establish reasonable care depending on their role and the circumstances.”100

92. Id.
93. Id.
94. Id. at 1224-25.
95. Id. at 1229.
96. Id. at 1228.
97. See id.
98. See id.
99. Id.
100. See H. BLOOMENTHAL, supra note 9, at 276-77.

[Another] disturbing aspect of the Sanders decision is the reliance on Section 11 precedents to impose liability on the underwriter [defendant] without regard to the distinction between expertised and non-expertised representations. The duty to make a reasonable investigation under Section 11 for the nonexpert is limited to the nonexpertised portion of a registration statement. With respect to the liability of such persons for expertised representations, there is no requirement that they have made a reasonable investigation.

Id.
The precise standard for determining the seller’s exercise of reasonable care, including any requirement that the seller make a “reasonable investigation,” remains unclear. Nonetheless, the Seventh Circuit’s emphasis on the selling underwriter’s obligation to make a reasonable investigation is consistent with the application of the section 12(2) remedy to the trading markets. The nature of the seller and her relationship to the purchaser, which was the focus of the analysis in Pinter, are likewise the proper focus for determining the scope of the seller’s burden in establishing the defense of “reasonable care.” The remainder of Part I of this Article emphasizes this point in its analysis of the applicability of the elements of section 12(2) to several hypothetical trading situations.

G. Applying Section 12(2) Elements to Fraudulent Postdistribution Trading: Examples

In Ballay v. Legg Mason Wood Walker, Inc., the plaintiff/investor group brought a section 12(2) suit against the defendant/brokerage firm, Legg Mason, alleging that the firm had solicited each of the plaintiffs to purchase stock in Wickes by means of oral misrepresentations concerning the book value of the pur-

101. See John Nuveen & Co. v. Sanders, 450 U.S. 1005 (1981) (denial of certiorari). Justice Powell’s opinion dissenting from the Court’s decision to deny review in Sanders reflects this uncertainty: “Although the opinion of the Court of Appeals is not explicit, it appears to impose a duty of ‘reasonable investigation’ rather than § 12 (2)’s requirement of ‘reasonable care.’” Id. at 1008 (Powell, J., dissenting).


103. Id. at 2-3. In another case involving oral misrepresentations, the court construed the phrase “oral communications” as used in § 12(2) to permit the defrauded secondary market buyer to bring a § 12(2) action. Elysian Fed. Sav. Bank v. First Interregional Equity Corp., 713 F. Supp. 737, 749-51 (D.N.J. 1989). In so ruling, the court observed: It is basically inclusion of the word “prospectus” in Section 12(2) (which is not included in Section 17(a), the Securities Act provision held applicable in the secondary market context) which defendants argue supplies the basis for reading the statute narrowly. Apart from the fact that the Third Circuit in Data Access emphasized the broad remedial purposes of the Securities Act (to “provide full and fair disclosure” in connection with interstate securities sales), defendants’ precise and well-refined analysis of certain words in the statute (or the absence of them), although thought provoking, does not compel the conclusion Section 12(2) was meant to apply only in connection with new securities offerings. If, on the other hand, Section 12(2) referred to a person who “offers a security by means of a prospectus or related oral communication,” it would be more clear the statute was not intended to apply to aftermarket transactions. Instead, Section 12(2) refers to the act of a person who “offers or sells” a security by means of a “prospectus or oral communication.” Id. at 750 (footnotes omitted).
The parties agreed that the defendant sold a security to the plaintiff by means of an oral communication that misstated or omitted a material fact of which the plaintiff/purchaser did not have knowledge. In this case, the brokerage firm used the facilities of interstate commerce, the mails, to describe material facts about Wickes stock—specifically, the book value—in a misleading fashion, and the purchaser had no knowledge of the disputed facts. Moreover, the defendant/brokerage firm was unable to establish that it did not know, and in the exercise of reasonable care, could not have known, of the misstatement or omission. This postdistribution trading transaction therefore satisfied all of the statutory prerequisites of a section 12(2) action.

One of the more hotly contested aspects of this case involved whether the defendant/brokerage firm was a seller for purposes of section 12(2). The district court found that the Supreme Court in Pinter v. Dahl had overruled the Third Circuit's strict privity requirement under section 12. The court in Ballay further found that the definition of "seller" in Pinter would apply to actions brought under section 12(2) on the grounds that "most authorities [conclude] that the language of sections 12(1) and 12(2) is identical in meaning," thus overruling defendant's claim that the analysis in Pinter is limited to claims under section 12(1). The court found that on the facts as established at trial, the defendant/brokerage firm successfully solicited plaintiffs' purchases of Wickes stock, "motivated at least in part by a desire to serve its own financial interests." This case demonstrates that nothing in the definition of "seller" in Pinter precludes its application to fraudulent sales activity by market professionals in connection with postdistribution trading.

104. Ballay, No. 88-6867 at 6 n.2.
105. Id.
106. Id. at 3.
107. Id. at 1-4.
108. Id. at 7-9.
109. Id. at 7-10.
110. Id. at 8.
111. Id. (quoting Pinter v. Dahl, 486 U.S. 622, 647 (1988)).
112. Indeed, most commentators agree that broker/dealers are the most likely group of prospective defendants to be included within the definition of "seller" in Pinter. See, e.g., 1 T. Hazen, supra note 31, at 325 ("Sales agents, however, such as brokers, are now likely to become the main targets of section 12 liability beyond actual purveyors of title, since often the broker conducts the sale.").
Clearly, these facts as found by the jury\textsuperscript{113} satisfy the elements of an express cause of action under section 12(2). One should also note that the plaintiffs in \textit{Ballay} prevailed in a suit against a brokerage firm, a securities professional. This fact presumably is important in establishing the standard of care that the brokerage firm owed to the purchasers. The few cases addressing the affirmative defense of reasonable care suggest that a different standard may apply depending upon the nature of the defendant and other attendant circumstances.\textsuperscript{114} In \textit{Ballay}, the brokerage firm was a seller because it successfully solicited plaintiffs' purchases and was motivated, at least in part, by its own financial interests, presumably receipt of a commission on the trade.\textsuperscript{115} To the extent the brokerage firm, as a securities professional, makes representations about the worth of the security, that firm has the obligation to be truthful, and under section 12(2) it has the further obligation to exercise reasonable care in making any such representations.\textsuperscript{116} Therefore, before a broker can make affirmative statements about the securities in question, she clearly has some obligation to investigate and ascertain the accuracy of any statements she would use to solicit prospective buyers' interest in the securities. The scope of this affirmative investigation responsibility is peculiarly a fact-driven inquiry that depends, at least in part, on issues such as the brokerage firm's relationship with the issuer, the extent of the broker's knowledge of the issuer's affairs, and what the broker wants to say to solicit investor interest.\textsuperscript{117}

But what of the seller who is sued under section 12(2) but who is not a broker/dealer or other type of market professional?\textsuperscript{118}

\textsuperscript{113} This case went to trial and the jury found in favor of the plaintiffs on their § 12(2) claims. \textit{Ballay}, No. 88-8867 at 3-4. Additionally, the jury returned a verdict in favor of defendants and against plaintiffs on their rule 10b-5 claims. \textit{Id.} Presumably then, the plaintiffs brought suit within the relevant time periods specified in § 13 (setting forth the statute of limitations for § 12(2) claims). \textit{See supra} note 89. Also, this jury verdict is consistent with the opinion of those commentators who predicted increased reliance on § 12(2) following the Supreme Court decision in \textit{Hochfelder}, which required rule 10b-5 plaintiffs to carry the higher burden of proving scienter. Section 12(2), by contrast, shifts the burden to the defendant to establish that it acted with "reasonable care."

\textsuperscript{114} \textit{See, e.g., supra} notes 90-101 and accompanying text.

\textsuperscript{115} \textit{Ballay}, No. 88-8867 at 7-9.

\textsuperscript{116} \textit{Id.}

\textsuperscript{117} \textit{See 1 T. Hazen, supra} note 31, at 316-17.

\textsuperscript{118} As another example, the brokerage firm in \textit{Ballay} may have acted as a principal and sold Wickes stock out of inventory to plaintiffs. In such a case, Legg Mason would
For example, in the context of the fact situation in Ballay, assume that Legg Mason acted as a broker and sold stock on behalf of its client, an anonymous seller. The seller, as transferor of title, did not make any misleading statements to the plaintiff/purchasers. The seller’s broker, Legg Mason, thus exclusively committed the wrongful conduct, which in this case consisted of material misstatements about the book value of Wickes stock. Further assume that the seller was a nonaffiliate of Wickes and a non-securities professional. She was simply an ordinary investor using the services of a broker/dealer to access the securities markets to dispose of her investment. In such a case, the ordinary investor acting as a seller should have a much easier time proving the section 12(2) affirmative defense of reasonable care. An ordinary, nonaffiliate investor is presumably held to a much lower standard of care than that required of Legg Mason as a securities professional. Under this more relaxed standard of care, the ordinary investor presumably would simply show that she took no affirmative steps to deceive the buyer, such as concealing material facts known to her. No further affirmative investigation of the issuer or its securities would be required of this nonaffiliate, non-securities professional seller to establish that she acted with reasonable care.

What of the situation in which the ordinary investor/nonaffiliate seller in a face-to-face transaction is aware of facts sufficient to put her on notice that further investigation may be warranted? Under section 12(2) decisional law, it appears that a securities professional, such as a brokerage firm like Legg Mason, would have a duty to investigate—that is, to make inquiries of the

have been the seller in the classic sense by virtue of being the transferor of title. Because the court had to apply the analysis in Pinter, however, to decide whether it could properly consider Legg Mason a seller in a § 12(2) suit, the court’s analysis suggests that Legg Mason could have been acting in a broker capacity and could have sold to plaintiffs Wickes stock that was owned by some third party, perhaps another customer of Legg Mason. In this case, it appears that plaintiffs did not sue the transferors of the Wickes stock, who, as the actual owners, would clearly be sellers under the analysis in Pinter. Assuming this was the case in Ballay, one must ask why the plaintiffs brought their case to trial against only the brokerage firm. Analysis of this question necessarily involves the seller’s § 12(2) affirmative defense of reasonable care. This same situation also may arise in the context of a direct sale between buyer and seller without the services of a broker as a financial intermediary. In such a case, presumably, no dispute would exist as to whether the defendant/owner is a seller because the defendant is also the actual transferor of title. Nevertheless, one may raise the same question as to the standard that the seller, as a nonsecurities professional, must satisfy to prove his or her affirmative defense of reasonable care under § 12(2).
relevant parties such as the issuer, to ascertain the material facts, and to make adequate disclosure of such information to the prospective buyer. By contrast, the case law is sparse as to the scope of investigation and disclosure required of the ordinary investor who is not a securities professional. The case law interpreting the level of care required to establish the section 12(2) affirmative defense generally speaks in terms of a sliding scale standard depending upon all of the facts and circumstances.\textsuperscript{119} Thus, the ordinary investor under section 12(2) should at most be required to disclose to the prospective buyer any suspicious facts and circumstances known to the seller/ordinary investor. The buyer can then decide whether further investigation is warranted and whether to make appropriate adjustments in the purchase price to reflect these additional costs.

To \textit{require} this nonaffiliate, nonsecurities professional seller to undertake an affirmative investigation simply because she is aware of suspicious facts seems inconsistent with the legislative purpose underlying the section 12(2) defense. By shifting proof of scienter to the seller as an affirmative defense under section 12(2), Congress intended to ease the plaintiff’s burden of proof.\textsuperscript{120} Congress believed that the defendant/seller, as the party generally closer to the relevant facts, would be in an easier position to prove her innocence than the plaintiff, who otherwise would have to undertake extensive discovery to ascertain facts necessary to establish the defendant’s state of mind.\textsuperscript{121} Congress clearly intended to modify common law causes of action to remove proof of scienter from plaintiff’s case-in-chief. No evidence suggests, however, that Congress intended by this shifting burden of proof to hold all sellers to the \textit{same} standard of care in proving their affirmative defense of reasonable care. Existing case law, although limited, does suggest that courts are to interpret “reasonable care” in light of all of the facts and circumstances of the particular situation, including the nature of the defendant/seller.\textsuperscript{122} Presumably common law principles can support a flexible standard that gives appropriate weight to the nature of the seller—such as an affiliate of the issuer, a securities professional, or an

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{119}.] See \textit{supra} notes 90-101 and accompanying text (discussing current authority interpreting the § 12(2) reasonable care standard).
\item[\textsuperscript{120}.] See \textit{supra} note 73 and accompanying text.
\item[\textsuperscript{121}.] See \textit{L. Loss, supra note 3}, at 1026.
\item[\textsuperscript{122}.] See \textit{id.} at 1028-29; \textit{1 T. Hazen, supra note 31}, at 316-17.
\end{enumerate}
\end{footnotesize}
ordinary investor—and to adjust the required standard of care accordingly.\textsuperscript{123}

The foregoing discussion of seller liability under section 12(2) has focused on face-to-face transactions between buyer and seller; but what about the open market buyer who purchases the security in an anonymous exchange or over-the-counter transaction? In these cases, the privity requirement again will substantially narrow the availability of section 12(2) relief.\textsuperscript{124} The purchaser can sue only \textit{Pinter}-type sellers, who generally can be identified through tracing, although the transaction costs may be prohibitively high.\textsuperscript{125} In any case, once the buyer determines the identity of the actual transferor, the buyer may rescind the transaction, assuming that her seller made any misleading statement "by means of a prospectus or oral communication."\textsuperscript{126} In the case of many open-market transactions, the seller is an ordinary investor disposing of her investment and has engaged in no actionable misconduct in connection with her decision to sell. On the other hand, a purchaser who can ultimately trace her seller to a market professional may try to claim that the seller was aware of facts

\begin{footnotes}
\textsuperscript{123} Indeed, the proposed Federal Securities Code carries forward this suggestion. See L. Loss, \textit{supra} note 3, at 1028-29 n.27 (quoting § 1704(g) of the proposed Federal Securities Code as promulgated by the American Law Institute. For a general description of this monumental undertaking, see L. Loss, \textit{supra} note 3, at 38-54). In any case, the precise scope of the seller's obligation to make a reasonable investigation in order to establish the § 12(2) reasonable care defense need not be defined to decide the more fundamental issue of whether § 12(2) relief is available to any defrauded purchaser who otherwise satisfies the procedural prerequisites of § 12(2). Further refinement of the scope of the seller's reasonable care defense is outside the scope of this Article.

\textsuperscript{124} At least one commentator has already made this observation:

While § 12(2), like § 10(b) and rule 10b-5, potentially applies to both primary distributions and secondary resales, this Article advocates a return to a relatively strict privity requirement for § 12(2), and therefore impacts on the ultimate availability of § 12(2), as compared with rule 10b-5, which does not require privity. For example, in a primary distribution undertaken through a firm commitment underwriting, a strict privity approach to § 12(2) limits each link in the distributive chain to a § 12(2) claim only against his immediate seller . . . . Similarly, while § 12(2) can reach a secondary resale, the privity requirement would undercut its availability in open market purchases since it is usually impossible to trace the actual seller in such transactions.

O'Hara, \textit{supra} note 16, at 929 n.18 (citations omitted).

\textsuperscript{125} In most situations, recovery may be prohibitively expensive because "it is usually impossible to trace the actual seller" in an open-market transaction. See \textit{id}. Further, these transaction costs may be excessive in light of the remedy available assuming the buyer's suit is successful on the merits and the seller's reasonable care defense fails.

\textsuperscript{126} See \textit{supra} text accompanying notes 60-73.
\end{footnotes}
that gave rise to an affirmative duty to investigate in order to satisfy the section 12(2) defense of reasonable care. In most situations, however, the plaintiff will face difficulty in establishing this claim because the open-market seller, in the absence of truly culpable conduct or acquiescence in wrongful nondisclosure, presumably made the decision to sell for independent reasons; her conduct, therefore, has not otherwise deprived her of the section 12(2) defense of reasonable care. In any case, the built-in privity requirement of section 12(2) has substantially narrowed the class of potential defendants.\textsuperscript{127}

II. LEGISLATIVE HISTORY AND TEXTUAL ANALYSIS OF SECTION 12(2)

As illustrated above, nothing in the statute's text limits the section 12(2) remedy only to distribution transactions. The cases denying a section 12(2) cause of action for fraudulent postdistribution trading, therefore, rely heavily on other "evidence" of legislative intent to support their decision to deny section 12(2) relief. Part II of this Article will demonstrate, however, that the sparse legislative history on section 12(2) itself reflects that Congress did not intend to limit the availability of this express remedy only to distribution transactions. An analysis of the relationship of section 12(2) to the other statutory provisions of the 1933 Act,\textsuperscript{128} as well as to other express and implied remedies

\textsuperscript{127} As an alternative to relying on the privity requirement of § 12(2) to determine its availability to a particular plaintiff, one commentator recently proposed to "amend § 12(2) to apply only to those aftermarket transactions where the market for the security is not efficient." \textit{Note, Applying Section 12(2) of the 1933 Act to the Aftermarket, 57 U. Chi. L. Rev. 955, 975 (1990)} [hereinafter \textit{Note, Applying Section 12(2) to the Aftermarket}].

The better approach, however, is to incorporate efficient market principles into the discussion of the level of care that any § 12(2) defendant/seller must show to prove her affirmative defense. For example, if the securities sold are issued by a company eligible to register on a Form S-3, the scope of investigation required of any seller (regardless of whether the seller is a securities professional, or an affiliate of the issuer, or possesses some other important distinguishing factor) may be very narrow because the issuer is widely followed in the marketplace. Accordingly, current evidence suggests that one may justifiably rely on the market price of the security to reflect all publicly available information. \textit{See, e.g., Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 Stan. L. Rev. 1031 (1977)}. Moreover, this approach to incorporating efficient market principles has the added advantage of flexibility, which does not characterize the approach proposed in \textit{Note, Applying Section 12(2) to the Aftermarket, supra}, involving congressional amendment to § 12(2) and many other attendant definitional problems.

\textsuperscript{128} This contextual analysis may be indicative of legislative intent. Because courts presume that Congress intended the consequences that flow from reading the statute as
LIABILITY UNDER SECTION 12(2) OF 1933 ACT

under the federal securities laws, further buttresses this conclusion.

A. Legislative History: In General

Adoption of the 1933 Act served a two-fold purpose. First, Congress intended to provide prospective investors with full disclosure through the section 5 registration obligation. Congress required issuers to provide "material" information to prospective investors with a sufficient cooling off period to afford investors an opportunity to review and evaluate the required items of disclosure. Disclosure, Congress thought, coupled with deliberative reflection by prospective investors, would promote sound investment decisions and discourage high pressure sales tactics and other abusive practices that, until the adoption of the 1933 Act, had allowed marginal and outright fraudulent investment schemes to flourish.

Second, Congress intended to outlaw fraud in connection with the offer and sale of any security, whether registered or unregistered. The 1933 Act was part of Congress' response to the excesses in the 1920's bull market, which collapsed dramati-

129. See R. JENNINGS & H. MARSH, supra note 9, at 63.
130. See supra notes 74-77 and accompanying text (discussing relevant standard of materiality).
131. See R. JENNINGS & H. MARSH, supra note 9, at 84-87.
132. Section 12(2) refers to the purchase of a security; it says nothing about the type of transaction. This silence is equally reflective of broad congressional intent to eliminate fraud wherever it occurs. Moreover, § 12(2) liability attaches to "any" person who offers or sells to the purchaser and is not limited on its face to distribution participants. If Congress wanted obligations to attach only to distribution participants, it knew how to do so; for example, see § 2(11)'s definition of "underwriter" and its use of the concept of "control person" and the complex relationship between this "underwriter" definition, the § 5 registration and prospectus delivery requirements, and the series of exemptions contained in § 4. Analyzing all of these statutory provisions together, one can see that Congress clearly intended the § 5 prospectus delivery requirements to attach only to distribution participants, including those participating in secondary distributions. See R. JENNINGS & H. MARSH, supra note 9, at 70, 453-54. Congress' failure to limit similarly the fraud prohibition of § 12(2) suggests that Congress intended § 12(2) liability to attach to any fraudulent transaction—whether in the primary or secondary markets.
133. Indeed, § 12(2) liability specifically attaches to misstatements or omissions of material fact in connection with registered or unregistered securities, except for those securities exempted by § 3(a)(2), which deals generally with government securities.
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cally on Black Monday, October 29, 1929. As the country grappled with the Great Depression, Congress resolved to reform the securities markets to prevent future casualties of this magnitude. It thought this legislation would outlaw those practices that existing common law remedies did not adequately redress. Congress therefore sought to create a regulatory structure with sufficient flexibility to detect and eliminate any new strains of fraudulent activity that Wall Street ingenuity might concoct in the postdepression markets—including both the distribution and the trading markets.

As such, the 1933 Act represented Congress’ first step: over the next seven years, Congress diligently worked to impose a viable regulatory structure on all segments of the Wall Street financial community. In 1933, at the time it adopted the first piece of legislation, Congress could not have foreseen, in any realistic way, the legislative developments that would occur over the following seven years, culminating with the enactment of the Investment Company Act of 1940 and the Investment Advisors Act of 1940. It is disingenuous, therefore, to assume that Congress intended, implicitly if not explicitly, to deny section 12(2) relief in the secondary markets because it planned to address the problem by the later statute, the 1934 Act. Indeed, as the congressional budget debates of fall 1990 have shown, one can never say with certainty whether Congress will adopt legislation in the future or—even if one is lucky and guesses correctly—that the ensuing statutory language will address adequately the wrongful conduct that Congress intended to target. One cannot say with any conviction, therefore, that Congress intended to limit the 1933 Act’s fraud prohibition in section 12(2) to distribution transactions.

It is not gainsaid, however, that Congress intended the 1933 Act’s fraud prohibition to reach broadly, that is, to eradicate fraud in securities sales wherever it occurs.

135. L. Loss, supra note 3, at 29-36.
136. See id.
137. See id. at 1022 (“Section 12(2) can perhaps best be analyzed and evaluated by comparing it with common law (or equitable) rescission from which it was adapted . . . .”).
138. See sources cited supra note 11.
141. See Abrams, supra note 36, at 905 (“The realities of the legislative process weaken any assumption that whenever Congress enacts a statute, the lawmakers perfomce know of all related federal statutes.”). Although the author is speaking to those statutes previously enacted, the comments are just as applicable with regard to Congress’ “knowledge” of “future” statutes.
Congress intended first and foremost to stamp out fraud; it could not risk leaving the provision of relief for fraud in the trading markets altogether to future legislation.\textsuperscript{142} Courts that deny section 12(2) relief to the defrauded purchaser\textsuperscript{143} in a secondary transaction do so primarily on the grounds that the section's legislative history indicates that Congress did not intend section 12(2) relief to reach the secondary markets.\textsuperscript{144} These courts most frequently rely on the following passage from Professor Loss' authoritative treatise as evidence of this legislative intent: "The 1933 Act is concerned primarily with distributions. Post-distribution trading was to be the subject of further legislation, which turned out to be the 1934 Act."\textsuperscript{146}

In the main, Professor Loss is correct, because the heart of the 1933 Act is section 5, which ultimately requires registration solely in connection with a "distribution" transaction.\textsuperscript{146} One

\textsuperscript{142} An interesting question that further supports this line of reasoning arises: Would we deny a § 12(2) cause of action to the defrauded buyer in a trading transaction had Congress not seen its way to adopt the 1934 Act? Moreover, would we deny a § 12(2) cause of action to defrauded purchasers had the courts not seen their way to imply a private remedy for damages pursuant to § 10(b) and its rule 10b-5? To pose the question is to shed some light on the legislative intent underlying § 12(2); at a minimum, Congress left the language flexible enough to allow the defrauded buyer in a trading transaction room to sue under § 12(2). This conclusion is buttressed by case law interpretation of the statutory language and legislative history of § 17(a)—the "other" fraud proscription in the 1933 Act. See infra notes 187-206 and accompanying text (discussing § 17(a)). Furthermore, it seems absurd to suggest that the existence of a remedy implied from the language of an administratively adopted rule promulgated pursuant to the authority of a later-enacted statute should operate to defeat the availability of an express cause of action enacted earlier by Congress. See infra notes 155-62 and accompanying text for a further discussion of the cumulative construction of express and implied remedies under the federal securities laws.

\textsuperscript{143.} The § 12(2) cause of action limits standing to defrauded purchasers only. Defrauded sellers have no relief under § 12(2). The failure of § 12(2) to permit recovery by defrauded sellers was at least part of the reason for creating an implied private remedy for damages under rule 10b-5. See H. BLOMENTHAL, supra note 9, at 312-13; R. HAMILTON, supra note 19, at 944-49. Congress' preoccupation with providing a more liberal remedy to defrauded buyers, while seemingly overlooking the plight of the defrauded seller, is logical in light of the types of fraud that were pervasive in the securities markets during the 1920's: insiders selling to unsophisticated customers securities that they knew, or had reason to believe, were worthless. Congress, quite naturally, was more concerned with the plight of the defrauded buyer in light of the seller abuses and fraudulent practices that had come to light during congressional hearings in the aftermath of the 1929 crash. See Abrams, supra note 36, at 919 n.247 and authorities collected therein.


\textsuperscript{145.} L. Loss, supra note 3, at 92.

\textsuperscript{146.} See R. JENNINGS & H. MARSH, supra note 9, at 63-64.
reaches this conclusion, however, only after careful analysis of the language of section 5 as qualified by the other provisions of the 1933 Act. Section 5's registration obligation is all-encompassing; on its face, section 5 requires registration in connection with any offer or sale, whether occurring in the distribution or trading markets.\footnote{147} Congress did not, however, intend to burden secondary trading markets with these additional transaction costs.\footnote{148} Congress implemented its intent through the exemptions set forth in section 4, most particularly section 4(1), which excludes ordinary trading transactions from the sphere of section 5's registration obligations.\footnote{149} One should not confuse these statutory registration obligations with fraud. Section 5 does not deal with fraud; fraud is prohibited by both section 12(2), which creates an express civil cause of action for damages,\footnote{150} and section 17, which criminalizes certain fraudulent activity.\footnote{151} The exemptions outlined in section 4 apply only for purposes of removing the transaction from section 5's registration obligation. Indeed, the plain language of the statute is quite clear that all transactions, whether registered or not, may be subject to section 12(2) liability for fraud. Although Congress intended to limit the registration obligation to distribution transactions, it clearly did not intend to limit similarly the reach of the fraud proscription.

Nonetheless, courts have taken this passage from Professor Loss' treatise out of context and have relied on it in a misleading fashion. Indeed, in \textit{Hoxworth v. Blinder Robinson},\footnote{152} the court rather pointedly observed that

\begin{quote}
Professor Loss merely states that the Securities Act of 1933 as a whole is primarily concerned with initial offerings. He
\end{quote}
does not say that not one section of it applies to subsequent trading. When Professor Loss does take up Section 12(2) specifically [in a later section of his treatise,] he states: "To start with what is clearest, the section applies to all sales of securities . . . "

Analysis of the relationship of section 12(2) to other aspects of the federal securities laws further supports the truth of Professor Loss' conclusion that section 12(2) applies to all sales of securities. The remainder of Part II of this Article therefore examines section 12(2)'s relationship to other specific provisions of the 1933 and 1934 Acts, as well as to the entirety of the federal securities laws. Consistent with recent Supreme Court instruction in the area of statutory interpretation of the federal securities laws, the goal of this contextual analysis is to discern Congress' underlying purpose so as to give appropriate force and effect to each provision of the federal securities laws, including section 12(2).

B. Cumulative Construction of Remedies

An important canon of statutory interpretation of the federal securities laws is that the law favors the cumulative construction of remedies. Historically, courts have liberally interpreted this principle to favor broad implication of private remedies to redress wrongful conduct in securities transactions. Recently, however, this principle has fallen to secondary importance in favor of an approach that focuses almost exclusively on legislative history.

Nevertheless, the Supreme Court recently relied on this principle in Herman & McLean v. Huddleston to permit an implied...

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153. Id. at 30 (emphasis added) (quoting L. Loss, supra note 3, at 1021).
154. See supra note 12 and accompanying text (discussing the approach that recent Supreme Court decisions have taken in interpreting specific provisions of the federal securities laws).
155. The Court expressly relied upon the cumulative construction of the remedies under the 1933 and 1934 Acts in its decision in Herman & MacLean v. Huddleston, 459 U.S. 375, 383-84 (1983) ("In saving clauses included in the 1933 and 1934 Acts, Congress rejected the notion that the express remedies of the securities laws would pre-empt all other rights of actions. . . . These [saving clauses] confirm that the remedies in each Act were to be supplemented by 'any and all' additional remedies.").
157. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-06 (1976); see also supra note 12 and accompanying text (discussing the proper approach to statutory interpretation of the federal securities laws).
158. 459 U.S. 375.
cause of action to be maintained in the face of a congressionally approved express cause of action which specifically addressed the fact situation presented in that case. In *Huddleston*, the Court concluded that a plaintiff may maintain a rule 10b-5 claim under the 1934 Act along with an express cause of action under section 11 of the 1933 Act for a misleading 1933 Act registration statement. The Court did not find that the later-enacted section 10(b) of the 1934 Act was in derogation of the express remedies under the 1933 Act.

Similarly, the Court's policy favoring cumulative construction of remedies in the federal securities law area supports the conclusion that a section 12(2) remedy is available for fraud in connection with secondary trading, notwithstanding the usual availability of implied remedies under section 10(b) and its rule 10b-5, and perhaps other express remedies as well. The purchaser, however, must be able to establish all of the elements of this express cause of action. These procedural restrictions tend in and of themselves to limit standing, thereby obviating any concern that a cumulative construction of the remedies will open the "floodgates of litigation."

C. Interpreting the Phrase "By Means of a Prospectus" as Used in Section 12(2)

An examination of the significance of the "by means of a prospectus" language as used in section 12(2) reveals another important relationship demonstrating that section 12(2) relief is not limited only to distribution transactions. The proper interpretation of this phrase in section 12(2) depends upon reference to the statutory definition of "prospectus" contained in section 159.

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159. *Id.* at 387.
160. *Id.* at 383-84.
162. This phrase is borrowed from Justice Rehnquist's opinion in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), in which the Supreme Court adopted the Birnbaum doctrine to limit standing in a rule 10b-5 suit only to actual purchasers and sellers. *Id.* at 730-31 (citing Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952)). In molding this limitation on the judicially crafted, implied remedy of rule 10b-5, the Court expressed its concern about the danger of vexatious litigation if it did not adopt this more restrictive rule of standing. *Id.* at 739-40. Here, however, standing to bring a § 12(2) suit is already limited to purchasers only, and the statute's built-in privity requirement has also significantly narrowed the class of potential defendants. Moreover, § 12(2) defendants may prove the affirmative defense of due care; the availability of this affirmative defense should further discourage unmeritorious litigation.
2(10) of the 1933 Act.\textsuperscript{163} Section 2(10) defines “prospectus” as essentially \textit{any writing} offering a security for sale.\textsuperscript{164} Courts have construed this language \textit{very} broadly.\textsuperscript{165} The few cases addressing this issue have defined “prospectus” consistently with the face value of the section 2(10) language: \textit{any written communication}, including without limitation letters, notices, prospectuses, and advertisements,\textsuperscript{166} offering \textit{any} security for sale or \textit{confirming} the sale of any security.\textsuperscript{167}

Congress' use of the term “prospectus” within the statutory definition of “prospectus” confirms that “prospectus” as used throughout the 1933 Act refers broadly to “any writing” offering a security for sale.\textsuperscript{168} The word “prospectus” as included in the statutory definition of the same term is presumably a reference to the stylized offering document commonly known in the securities industry as a “prospectus.” Congress, however, specifically made the offering prospectus document just one of many categories of writings to be included within the statutory definition of the term “prospectus.” Because Congress so carefully crafted the set of definitions for use throughout the statute's remaining provisions, it is difficult, if not impossible, to conclude that

\begin{itemize}
\item \textsuperscript{163} 15 U.S.C. § 77b(10) (1988). Admittedly, the exceptions to this definition (that is, § 2(10)(a) describing tombstone ads and § 2(10)(b) describing the free-writing privilege) do not directly describe documents commonly used in connection with secondary trading, the negative implication being that Congress intended to limit the definition of “prospectus” to those documents commonly used in connection with public offerings. Any such negative implication, however, is overcome by evidence that where Congress intended to specifically describe “prospectus” it knew how to do so. See, e.g., § 5(b)(2), 15 U.S.C. § 77e(b)(2) (specifically referring to a prospectus meeting the requirements of § 10(a)—a writing commonly known as a statutory prospectus).
\item In addition, Congress specifically included in the § 2(10) “prospectus” definition any writing that “confirms the sale of any security.” See 15 U.S.C. § 77b(10). A “confirmation,” in securities industry jargon, generally refers to the document that brokers use to confirm execution of a customer’s order previously placed with the broker. Significantly, the confirmation slip generally is issued in connection with both distribution and postdistribution transactions. Indeed, for many investors, “confirmation” is a term of art most commonly understood by reference to the trading markets. See also Rule 10b-10, 17 C.F.R. § 240.10b-10 (1990) (the “confirmation” rule adopted under the 1934 Act). The literal language of the statutory definition of “prospectus” thus provides no support for an implied limitation on § 12(2) to distribution transactions only; if anything, the statute on its face embraces both kinds of transactions.
\item \textsuperscript{164} See R. Jennings & H. Marsh, supra note 9, at 85.
\item \textsuperscript{165} See 1 L. Loss & J. Seligman, Securities Regulation 463 n.173 (3d ed. 1989).
\item \textsuperscript{166} The § 2(10) definition of “prospectus” also includes radio or television advertisements. See infra note 177 (discussing the narrow area in which analysis of the term “oral communication”—which presumably could include radio or TV media communications—may impact whether a particular writing or document is a prospectus).
\item \textsuperscript{167} 1 L. Loss & J. Seligman, supra note 165, at 463 n.173 and accompanying text.
\item \textsuperscript{168} Id.
\end{itemize}
Congress intended to use this stylized industry reference to an offering circular as the relevant definition of "prospectus" for purposes of section 12(2). It hardly seems logical to assume that legislators would labor to draft these specific definitions for terms of common usage in the industry only to cast them aside in a subsequent section without any clear indication of such an intent. Nevertheless, the courts that have denied section 12(2) relief in the case of postdistribution trading seem to have assumed that the prospectus referred to in section 12(2) is the prospectus commonly associated with initial offerings. This understanding is flawed, however, because it completely overlooks the broad section 2(10) definition of "prospectus," as well as the carefully qualified use of the term "prospectus" in subsequent provisions of the 1933 Act.

In subsequent sections of the 1933 Act, Congress specifically delineated certain types of prospectuses, that is, certain writings that would meet specific, congressionally imposed criteria for the purpose of implementing the Act's disclosure requirements. Section 10 of the 1933 Act describes two types of prospectuses. Section 10(a) is generally referred to as the "statutory" or "final" prospectus, because Congress mandated that it contain all of the information required by Schedule A of the Act. Section 10(b), on the other hand, authorizes preparation of a "preliminary


170. See 15 U.S.C. § 77j(a) (1988). Section 5(a) requires delivery of a statutory prospectus prior to "sale." Id. § 77e(a). McCowan v. Dean Witter Reynolds Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,423 (S.D.N.Y. 1989), provides a good illustration of the confusion that a court's reasoning can create if it fails to appreciate fully the complex structure of the 1933 Act and the importance of the § 2(10) definition of "prospectus." The court in McCowan incorrectly believed that the securities must be issued pursuant to a faulty § 10(a) type of prospectus in order for a plaintiff to pursue a § 12(2) action. Id. at 92,726.

The court, however, either completely overlooked or misapprehended the scope of the § 2(10) definition of "prospectus." This misunderstanding is reflected in footnote five of the court's opinion, in which the court observed that

plaintiffs' argument that [the defendant's] monthly statements and confirmations to plaintiffs were "prospectuses" for the purposes of Section 12(2) is frivolous. The purpose of a "prospectus" is to provide information about forthcoming events, not past events. Even if defendant's monthly statements may be considered "prospectuses," they remain unrelated to the initial public distribution of the securities purchased from defendant. Id. at 92,727 n.5. The court's reasoning, however, completely overlooks those decisions that have expressly found a confirmation to be a prospectus. See, e.g., Byrnes v. Faulkner, Dawkins, & Sullivan, 550 F.2d 1303, 1309-10 (2d Cir. 1977); see also § 2(10), 15 U.S.C. § 77m(10) (which expressly includes "confirmation" within the statutory definition of "prospectus").
prospectus,” which is a writing that sets forth the information required by any rule that the SEC adopts pursuant to the rulemaking authority delegated to it in section 10(b). Section 10(b) is not self-executing; in the absence of an enabling rule, section 10(b) does not, by its own terms, authorize the use of any particular “writing”—that is, “prospectus”—in the section 2(10) definitional sense.

The cases denying section 12(2) liability for fraudulent activity in trading markets inappropriately limit the interpretation of the term “prospectus” as used in section 12(2). None of the cases discuss the elaborate definitional structure of this term set forth by Congress in the statute. For example, in SSH Co. v. Shearson Lehman Bros., the court mistakenly concluded that “[t]he phrase ‘prospectus or oral communication’ refers to a prospectus, registration statement, or other communication related to batch offering of securities, not to subsequent trading.”

The weaknesses of this conclusion are manifold. First, the court offered no support in the statute or in the legislative history for its interpretation. Moreover, the court did not take into account the elaborate definitional structure of the term “prospectus” that Congress specifically set forth in the 1933 Act. It hardly seems plausible that Congress intended the courts to ignore its extensive definitional treatment in favor of an implied modification limiting the “prospectus” definition to “communication[s] related to batch offering[s] of securities.”

172. Pursuant to its § 10(b) rulemaking authority, the SEC has promulgated rules describing prospectuses that satisfy § 10(b), which sellers therefore may use for purposes of the prospectus delivery requirements of § 5(b)(1). See 17 C.F.R. §§ 230.430, 230.430A, 230.431 (1990).
175. Id. at 1059.
176. The court in SSH Co. relied upon a number of cases, all of which it used to support the proposition that the § 12(2) plaintiff “must prove that his shares were issued pursuant to the defective prospectus.” Klein, 591 F. Supp. at 277-78 (emphasis added). The court in SSH Co., like the courts to which it cited, failed to acknowledge the 1933 Act’s extensive definitional treatment of this term. Instead, these courts relied on the bald assertion that the “purpose of the [1933 Act was the regulation of the distribution of securities. Post-distribution trading is regulated by the [1934 Act.” SSH Co., 678 F. Supp. at 1059.
177. SSH Co., 678 F. Supp. at 1059. Another weakness of the approach used by the
Presumably, one should equate the court's use of "batch offerings" with the concept of "distribution" as that term is later used by the court in *SSH Co.* The court in *SSH Co.*, however, must have had a better grasp of this rather elusive concept than Congress did; Congress did not define the critically important concept of "distribution." As a result, the courts have struggled

...court in *SSH Co.* is that it overlooks a whole host of writings thought to be subject to § 12(2)'s fraud prohibition. Such writings include private offering memoranda, selling literature in the free-writing period, Regulation D offering circulars, and so on, all of which would be considered a prospectus within the § 2(10) definition but which may not be thought of as a prospectus in the sense that the court in *SSH Co.* and other courts have used that term. As one commentator has observed:

Section 12(2) is the only express remedy relating to the sale of securities offered pursuant to an exemption and, in the light of Regulation D, has an increasingly important role to play in terms of policing exemptions. It is also applicable to fraud committed in connection with the sale of securities by broker-dealers in organized trading markets and to negotiated transactions effectuated outside of the organized securities markets. Section 12(2) is not an exclusive remedy as defrauded purchasers also have a remedy under rule 10b-5 and possibly other fraud provisions.

H. Bloomenthal, *supra* note 9, at 274.

Moreover, the use of the disjunctive in § 12(2) to include "prospectus" or oral communication suggests that Congress intended to rely on the broad § 2(10) definition of "prospectus" and did not intend to restrict this term to refer to new public offerings. Indeed, relying on the broad § 2(10) definition of "prospectus" helps to make better sense of the statute's unqualified use of the phrase "or oral communication." In *Grinsell*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,437, the issue presented required the court to interpret the phrase "by means of a prospectus or oral communication" as used in § 12(2). The defendant/broker argued that the legislative history of the 1933 Act suggests that the words "prospectus or oral communication" clearly "limit [the] application of Section 12(2) to communications connected with an initial stock offering, and exclude statements made pursuant to subsequent secondary market transactions." Id. at 97,229-30. The plaintiff pointed to the same statutory language and argued that all oral communications of the type prohibited by the statute were actionable, whether or not made in conjunction with an initial stock offering. Id. at 97,230. In agreeing with the defendant and refusing the plaintiff a § 12(2) cause of action, the court in *Grinsell* ignored the definition of "prospectus" contained in § 2(10). Id. at 97,231.

On the other hand, the district court in Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989), in construing the same phrase, "oral communication," concluded that if Congress "intended to so narrowly limit the application of Section 12(2), more narrow words were available to do so," such as linking the oral communication to the term "prospectus" by such phrasing as "or related communication." Id. at 750 n.17. The court in *Elysian* reached the better result, but its reasoning is subject to the same criticism as that of the court in *Grinsell* because of its failure to take into account the statutory definition of "prospectus." In any case, the differing conclusions of the two courts show that one cannot properly analyze the language of § 12(2) without reference to § 2, the statute's definitional section.

178. *See SSH Co.*, 678 F. Supp. at 1059 ("The purpose of the 1933 Act was the regulation of the distribution of securities.").

with this concept,180 as has the SEC.181 These efforts show that neither courts nor agencies can easily define the concept of "distribution"182 and that its definition most certainly spills over to include some, although not all, secondary transactions.183 It is now suggested, however, that this difficult line drawing should be superimposed onto the availability of section 12(2) relief. To imply a limitation that section 12(2), and indeed the 1933 Act as a whole, reaches only distribution transactions requires the courts to engage in difficult line drawing problems, that is, whether given transactions involve distributions. Which of the various concerns that the courts and the SEC have used to flesh out this concept should be emphasized in deciding whether a given transaction involves a "distribution"?184 Obviously, this inquiry is particularly fact driven and courts must resolve it on a case-by-case basis. The definition of "prospectus," interpreted as part of the statutory whole of the 1933 Act, provides ample guidance and


181. See Rule 144, 17 C.F.R. § 230.144; Rule 10b-6, 17 C.F.R. § 240.10b-6.

182. Note, however, that most of the situations in which the courts and the SEC have struggled to define "distribution" involve an effort to define "distribution" for purposes of determining a party's obligation to comply with the § 5 registration and prospectus delivery requirements. Presumably, Congress did not intend to limit the § 12(2) fraud prohibition only to distribution transactions because § 12(2) clearly states that it applies to any person selling any security. The statutory language of § 12(2) nowhere alludes to the concept of a "distribution," although Congress was well aware of this concept and its significance. Congress' appreciation for the significance of the term "distribution" is reflected in the critical role that this concept plays in the § 4(2) exemption and in the § 2(11) definition of "underwriter".

183. See H. BLOOMENTHAL, supra note 9, at 221 (discussing concept of "secondary distributions").

184. The contours of a "distribution" are not affirmatively defined by statute or by SEC rule, although as noted above, this concept is very important. See, e.g., Rule 10b-6 (defining "distribution" for purposes of the stabilization rules); Rule 144 (defining what is not a "distribution" for purposes of, inter alia, the § 4(1) and § 4(3) exemptions). The court's reliance on public offering/distribution transactions as the guide to determine which "writings" will be subject to § 12(2) liability necessarily requires the court to "legislate" the relevant criteria. To follow this course is contrary to recent Supreme Court instruction in this area, which has called on the lower courts to remain true to the specific language of the statute and to the congressional intent behind that language. See Abrams, supra note 36, at 878-80.
obviates any need for the courts to engage in the illusory business of defining "distributions."\textsuperscript{185}

D. Relationship Between Section 17(a) and Section 12(2) of the 1933 Act

The relationship between section 17(a) and section 12(2) of the 1933 Act also demonstrates that the defrauded buyer may avail herself of the section 12(2) remedy in a trading market transaction. Sections 17(a) and 12(2) overlap to some extent; section 17(a) criminalizes certain fraudulent conduct, whereas scholars have described section 12(2) as "the civil liability analogue to § 17."\textsuperscript{186}

Courts frequently rely on the Supreme Court's decision in United States v. Naftalin,\textsuperscript{187} which interpreted section 17(a), as evidence that Congress did not intend section 12(2) to give rise to liability in connection with postdistribution trading.\textsuperscript{188} In Naftalin, the Court observed:

\textsuperscript{185} This Article maintains that the better way, and the one most consistent with legislative intent, is to look to the plain meaning of the statute's definition section and to rely on the express procedural restrictions—in particular, the built-in privity requirement—to limit the availability of the § 12(2) remedy. This approach is preferable to grafting artificially some sort of standing limitation onto § 12(2)—that is, limiting § 12(2) purchasers to those defrauded by prospectuses or writings used during the course of a distribution transaction. As one commentator has observed:

\begin{quote}
[Section] 12(2) on its face applies to the offer or sale of any security. Thus, subject to this exception and limited to the sales side of a transaction, § 12(2) is coextensive in coverage with rule 10b-5 in terms of applying to both primary distributions of securities, whether or not registered under the 1933 Act, and secondary resales of securities, whether traded on a national securities exchange, in the over-the-counter securities market, or in a private transaction involving the securities of a closely held corporation. O'Hara, supra note 16, at 928 n.18 (citation omitted).
\end{quote}

Moreover, this straightforward adherence to the language of the statute avoids the quagmire of deciding such niceties as "when [is] the distribution transaction over," thereby cutting off § 12(2) standing to any other "open-market purchasers." Resolution of this issue would require the court to take up integration principles, which would generally require a judicial hearing as integration is also peculiarly a fact-driven inquiry. See Exemption for Local Offerings from Registration, Securities Act Release No. 4494, 1 Fed. Sec. L. Rep. (CCH) ¶ 2272 (Oct. 10, 1973) (discussing concept of "single issue" and setting forth the relevant factors in making this factual determination). Reliance on the privity requirement is a more efficient mechanism in the determination of standing than the more slippery concept of defining "distribution."

\textsuperscript{186} See 1 L. Loss & J. Seligman, supra note 165, at 384.

\textsuperscript{187} 441 U.S. 768 (1979). In its decision, the Court held that § 17(a) of the 1933 Act applied to secondary market trading "despite the contention that that was the province of Rule 10b-5 [of the 1934 Act] and that §17(a) should be limited to distributions." L. Loss, supra note 3, at 1151.

Although it is true that the 1933 Act was primarily concerned with the regulation of new offerings, defendant's argument fails because the antifraud prohibition of § 17(a) was meant as a major departure from that limitation. Unlike much of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading.\textsuperscript{189}

The Court's opinion recognized that the "primary" purpose of the 1933 Act was to regulate new offerings through the section 5 disclosure requirements.\textsuperscript{190} The 1933 Act disclosure requirements, which were the limitation to which the Court vaguely referred, were the then newly imposed set of disclosure and prospectus delivery requirements as established by section 5, the heart of the 1933 Act. The Court thus saw section 17(a) as a "major departure" from those new requirements. The Court's reference to section 17(a) as a "major departure" is consistent with finding section 12(2) applicable to postdistribution trading if the "limitation" to which the Supreme Court referred is the disclosure requirements of the 1933 Act. In this way, both sections 12(2) and 17(a) can be seen as "major departures" from the "limitations" newly imposed by the 1933 Act: those specific registration and disclosure requirements imposed on new offerings. The departure to which the Supreme Court referred is a departure from the registration requirements, which admittedly are the 1933 Act's primary focus.

One should not regard section 17(a) as the only "departure" intended to address trading market abuses. Rather, consistent with the section 4(1) trading exemption,\textsuperscript{191} one should read sections 12(2) and 17(a) as imposing fraud liability in any situation that satisfies the other prerequisites of these two sections.\textsuperscript{192} Indeed, a number of courts have recently denied an implied remedy under section 17(a) for damages,\textsuperscript{193} grounding the denial,

\textsuperscript{189} Naftalin, 441 U.S. at 777-78 (emphasis added).
\textsuperscript{190} Id. at 775.
\textsuperscript{191} See supra notes 148-49 and accompanying text (discussing the § 4(1) exemption, which serves to remove most ordinary trading transactions from the newly imposed disclosure and registration requirements of § 5).
\textsuperscript{192} Whether § 17(a) contains an implied private cause of action is an open question today, see Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.2 (1983), although the great weight of authority contends that § 17(a) contains no implied private remedy. See 2 T. Hazen, supra note 31, at 182-84; L. Loss, supra note 3, at 1148.
at least in part, on the notion that Congress intended the express remedy of section 12(2), along with its well-thought-out procedural restrictions, to be the injured parties’ statutorily prescribed recourse for any harm suffered.\footnote{194} To now imply a limitation on this remedy—not otherwise explicitly suggested by statutory language or legislative history—seems contradictory to, and undermines the reasoning of, these section 17(a) cases.

In support of its conclusion that Congress intended section 17(a) to criminalize fraudulent conduct occurring in the trading markets, the Court in \textit{Naftalin} relied on the Senate Report accompanying that section, which stated:

\begin{quote}
The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues put out after the approval of the act. In other words, fraud or deception in the sale of securities may be prosecuted regardless of whether the security is old or new, or whether or not it is of the class of securities exempted under sections 11 or 12.\footnote{195}
\end{quote}

Significantly, the Court emphasized that the language of section 17(a) itself makes “abundantly clear” that “no distinctions between the two kinds of transactions” exist.\footnote{196} The Court went beyond the statutory language and relied on the quoted excerpt from the Senate Report as further evidence of that which the statute made clear on its face: section 17(a) applies to ordinary trading transactions. The Court believed that Congress had spoken plainly, and therefore it “declined to manufacture ambiguity where none exists.”\footnote{197} In reaching this result, the Court expressly acknowledged that the 1933 and the 1934 Acts do indeed “prohibit some of the same conduct.”\footnote{198} “But ‘[t]he fact that there may well be some overlap is neither unusual nor unfortunate.’”\footnote{199}

Finally, the Court in \textit{Naftalin} observed that

\begin{quote}
either this Court nor Congress has ever suggested that investor protection was the \textit{sole} purpose of the Securities Act. . . .
\end{quote}

\begin{footnotes}
196. Id.
197. Id. at 779 (quoting United States v. \textit{Culbert}, 435 U.S. 371, 379 (1978)).
198. Id. at 778; \textit{see also} 3 L. Loss, \textit{supra} note 194, at 1428 (commenting that both the 1933 Act and the 1934 Act contain antifraud provisions).
\end{footnotes}
Prevention of frauds against investors was surely a key part of [the purpose of the Act], but so was the effort "to achieve a high standard of business ethics . . . in every facet of the securities industry."200

The Court relied on this quoted passage to reject any claim that protection of investors was the exclusive concern behind Congress' enactment of the 1933 Act and therefore did not address fraud that harmed only brokers and not investors. The Court broadly emphasized that Congress was worried about evils much more far ranging than the narrow set of circumstances the defendant put forward in Naftalin.201 The legislative history of the 1933 Act requires the Court to reach the same conclusion regarding the scope of potential liability under section 12(2).

The court in Ballay v. Legg Mason Wood Walker, Inc.202 emphasized this view of the Naftalin decision. Acknowledging that the Supreme Court described the 1933 Act as "primarily concerned with the regulation of new offerings,"203 the court in Ballay also observed that the Court's discussion in Naftalin was limited to the antifraud provisions of section 17(a); thus, its vague characterization of the remainder of the 1933 Act as dealing with nontrading markets was dicta.204 In other words, the fraud provisions of the statute are distinct from the registration obligations of the statute, which are admittedly intended to apply only to distribution transactions.205 The court in Ballay therefore concluded that the Supreme Court's finding that the anti-fraud prohibition of Section 17(a) "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the [course] of ordinary market trading" should apply to the other anti-fraud provision of 1933 Act as well. After all, it has been noted that Sections 17 and 12(2) serve the dual purpose of "rendering unlawful and authoriz[ing] civil recovery for fraud and misrepresentation in the sale of securities."206

200. Id. at 775 (quoting SEC v. Capital Gains Bureau, 375 U.S. 180, 186-87 (1963)); see also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (noting that one of the purposes of the 1933 Act was to "promote ethical standards of honesty and fair dealing"); United States v. Brown, 555 F.2d 336, 338-39 (2d Cir. 1977) (declaring that the 1933 Act is not solely limited to the protection of investors).
201. Naftalin, 441 U.S. at 775-76.
203. Id. at 13 (quoting Naftalin, 441 U.S. at 777-78).
204. Id.
205. Id. at 13-15.
206. Id. at 14 (quoting Wilko v. Swan, 127 F. Supp. 55, 58 (S.D.N.Y. 1955)).
Indeed, the fact that the Court found section 17(a) to apply to postdistribution trading is equally suggestive that section 12(2) should likewise apply to trading transactions. As with section 17(a), nothing in the language of section 12(2) limits its availability only to distribution purchasers. Moreover, when looking to the legislative history, one finds no suggestion that Congress intended a court to graft onto the express procedural restrictions the further limitation that section 12(2) liability attach only to fraud occurring in connection with "distribution" transactions. The district court cases denying section 12(2) relief to secondary market buyers have broadly suggested that section 12(2) should be so limited because of some vague notion that the 1933 Act is "primarily" concerned with distribution activity. Permitting recovery by defrauded secondary market buyers, however, is consistent with the understanding that the 1933 Act is directed primarily at distribution activity, but also creates a civil fraud remedy that applies to all securities transactions, in the same fashion as does the criminal penalty of section 17(a). Nothing in Naftalin contradicts this view.

E. Measure of Damages in a Section 12 Suit

The measure of damages that Congress prescribed in section 12 further indicates that Congress must have contemplated that a section 12 cause of action would extend to the defrauded buyer in a secondary market transaction.

Sellers may be held liable for a rescissionary measure of damages in section 12(2) actions.\textsuperscript{207} A section 12(2) rescission suit contemplates either return of the original purchase price to the buyer upon tender of the security or a rescissionary measure of damages calculated as the difference between the price paid and the value at the time of suit or the amount received on resale in the event that the security is sold during the pendency of, or before, the suit.\textsuperscript{208} For example, assume Insider induced Buyer to purchase from Insider one unit of ABC Company common stock at twelve dollars per share. Buyer then discovers that Insider purposefully deceived her about the company's financial affairs. If Buyer still holds the security, she may sue for rescission under section 12(2) and tender the share in return for the twelve

\textsuperscript{207} 1 T. HAZEN, supra note 31, at 331.
\textsuperscript{208} In calculating damages, a court also must take into account certain other statutorily required modifications. See § 12(2) (for example, plus interest, less dividends received).
dollars consideration paid. On the other hand, if Buyer has disposed of the security in the trading market at ten dollars per share, Buyer may recover two dollars from Insider, representing the difference between the twelve dollars price paid and the ten dollars amount received on resale to Buyer Number 2 (B2). What then about B2, the Buyer’s transeree? Assuming the price does not decline further, B2 has not suffered any harm. If, however, the stock further declines to seven dollars, B2 may have a cause of action against Buyer Number 1 (B1), assuming that B1 participated in the fraud and therefore cannot establish her affirmative defense of reasonable care. In such a case, B2 may tender the security and recover her ten dollar purchase price from her seller, B1. Alternatively, if B2 sold the stock when it declined to seven dollars, then B2 could recover three dollars from B1, representing the difference between the price paid (ten dollars) and the amount for which B2 sold the stock (seven dollars). In any case, B2 cannot recover from Insider under section 12(2) because no privity exists.

This hypothetical section 12(2) damages calculation shows that the section 12(2) procedural restrictions, particularly the built-in privity requirement coupled with the seller’s affirmative defense of reasonable care, can substantially limit the buyer’s ability to recover under the section 12(2) express cause of action. At the same time, however, the very nature of the remedy allowable under section 12(2) suggests that Congress anticipated that a buyer in a secondary market transaction would recover. Moreover, section 12(2) places no cap on plaintiff’s damages, unlike section 11 which expressly limits plaintiff’s recovery to the amount for which the security was sold in the initial, fixed price registered distribution, even if that amount would not make plaintiff whole.209

209. For example, in the case of a hot issue, the stock may sell at the fixed public offering price of $12 and immediately trade in the aftermarket at a substantial premium. Assume that the price rises and that B1 (who purchased in the public offering at $12) sells to B2 at $18; the fraud is subsequently discovered, causing the price to slide back down to $12. In this situation, B1 has no cause of action because B1 has suffered no harm. On the other hand, B2 (who satisfies the linear privity requirement by purchasing in the aftermarket a unit sold pursuant to the defective registration statement) has been harmed by the transaction because she paid $18 for stock worth $12 had the fraud not occurred. Nevertheless, B2 cannot recover the $6 loss from any of the § 11 defendants because § 11 limits liability to the amount for which the stock was sold in the public offering—here, $12. In the event, however, that the stock slides further before the § 13 limitations period expires, say to $9, B2 may recover $3 under a § 11 claim, representing the difference between the public offering price ($12) and its value at the time of the
Analysis of the measure of damages under section 11, as contrasted with section 12’s formulation, bolsters this conclusion. Although not expressly provided for in the statute, most courts limit recovery under section 11 to those plaintiffs who satisfy the judicially imposed linear privity requirement; that is, the plaintiff must be able to trace the securities she purchased to those that were the subject of the defective registration statement. This requirement arose out of the courts’ interpretation of the phrase “such security” as used in section 11(a). Commentators have criticized this requirement, however, on the grounds that it gives a windfall to these holders because they are able to improve their position over other holders of the same instrument who cannot satisfy this tracing requirement.

suit ($9). This recovery does not make B2 whole, however, because it does not allow B2 to recover the $8 premium paid in the aftermarket. On the other hand, a § 12(2) suit would allow B2 to sue B1 for the $18 purchase price paid by B2. Although B2’s suit against B1 satisfies the § 12(2) privity requirement, B2 may be precluded from any recovery if B1 can prove the defense of reasonable care. Moreover, B2 is not in privity with any § 11 defendants or B1’s seller and therefore cannot recover under § 12(2) against any of the perpetrators of the fraud because of the failure to satisfy the privity requirement.

210. See Barnes v. Osofsky, 373 F.2d 269, 271-72 (2d Cir. 1967) (interpreting “such security” as referring to those securities that were the subject of the defective registration statement, thereby creating the judicially imposed “linear privity” requirement). In the case of a first time registrant, all securities trading in the postdistribution market generally will be sold pursuant to the allegedly defective registration statement, or at least one should be able to ascertain readily if that is the case. To the extent there are additional units of the same class as those issued pursuant to the allegedly defective registration statement, these other units probably were legended pursuant to a 1933 registration exemption. Generally speaking, securities issued in an exempt transaction are “restricted,” that is, not freely tradeable, and are legended accordingly. In the case of an initial public offering, therefore, identification and segregation of the units that were issued as part of the registered offering is usually easy. Contrast this, however, with the situation of an established issuer selling additional units of a class that is already issued and outstanding and therefore subject to secondary market trading. In that situation, identification of those units that were issued pursuant to the allegedly defective registration statement is more difficult and therefore more costly. Nevertheless, this is an important threshold question in the case of a § 11 suit because only the holders of shares that were “the subject of the [defective] registration statement” may recover. Others, even though similarly situated and likewise harmed by the materially misleading registration statement, cannot recover in a § 11 fraud suit, although they may have other remedies available to them, such as rule 10b-5, § 12(2), or § 17(a), assuming they can otherwise satisfy the prerequisites of these remedies.


212. Scholars have criticized this interpretation of the damages calculation under § 11. See, e.g., L. Loss, supra note 3, at 1038 n.64, wherein the author observed: “The open-market buyer, however, must be able to trace his particular securities to the registration statement when it covered additional securities of an outstanding class. This is a nonsensical, but unavoidable, result of a statutory scheme that registers not classes but units of securities.”
The damages calculation that section 11 prescribes clearly does not limit recovery only to those who purchased in a distribution transaction. Rather, it expressly contemplates suit by an "open-market buyer," meaning a purchaser in the postdistribution market, who otherwise satisfies the procedural restrictions of this express cause of action. This feature of section 11 recovery is of particular importance in deciding whether section 12(2) liability should similarly extend to open-market buyers. Of the two express causes of action under the 1933 Act, section 11 relates more directly to fraud in the distribution market by virtue of being tailored narrowly to redress material misstatements or omissions in the registration statement. It hardly seems likely that Congress intended to permit open-market buyers to bring a section 11 cause of action, assuming they otherwise met the procedural restrictions of that section, but in the next section, section 12(2), intended to deny the defrauded open-market buyer a section 12(2) cause of action simply because the transaction involved postdistribution trading. The statutorily prescribed measure of damages, therefore, clearly contemplates that section 12(2) is available to defrauded buyers outside the context of initial distributions or, at a minimum, does not measure damages in such a fashion as to preclude application of this formula to fraudulent postdistribution trading transactions.

F. Interpreting the Phrase "Such Security" as Used in Section 12

Many of those district courts that deny section 12(2) relief to the secondary market buyer have done so based on an inappropriate interpretation of the phrase "such security" as used in section 12(2). The rationale of these decisions is impermissibly reminiscent of the linear privity requirement judicially imposed under section 11 to reach the proper interpretation of the phrase "such security" as used in section 11. Gross v. Diversified Mortgage Investors is one of the earliest decisions denying the plaintiff a section 12(2) cause of action.


against her seller in a case in which the transaction admittedly occurred in the postdistribution market.\footnote{215} In dismissing the section 12 cause of action, the court reasoned: "By the term 'such security' [as used in section 12(2)] Congress meant only the securities issued and sold pursuant to the registration statement and prospectus.”\footnote{216}

The court’s reliance on \textit{Barnes v. Osofsky},\footnote{217} a case interpreting the phrase “such security” as used in section 11, is misplaced because the section 12 use of the same phrase is completely different from both a grammatical and a policy perspective. Grammatically, section 11 uses the phrase “such security” to refer to those securities that are the subject of an effective registration statement. In comparison, section 12 uses “such security” to refer to two different situations: first, the situation of the security sold without satisfying the section 5 registration requirement in violation of section 12(1); and second, a security sold “by means of” a fraudulent “prospectus or oral communication” in violation of section 12(2). Congress used the phrase “such security” to modify both subsections of section 12 and thereby created the privity requirement of this modified rescission cause of action. Because the phrase does modify both subsections and because both subsections are clear that liability may arise in the absence of registration,\footnote{218} clearly the use of the phrase “such security” does not signify any congressional intent to refer to “only the securities issued and sold pursuant to the registration statement and prospectus.”\footnote{219}

The court’s reliance on \textit{Barnes} and its progeny is similarly misplaced from a policy perspective. The court in \textit{Barnes} was aware that Congress imposed section 11 liability on the enumer-

\footnote{215. Although the facts are somewhat sketchy, the plaintiffs alleged that subsequent to their initial purchases, the issuer filed a registration statement relating to the sale of debentures. The debentures, however, were never issued and the underlying registration statement and prospectus were later withdrawn. The plaintiff accordingly did not pursue a § 11 suit against the seller. \textit{Id.} at 1095.}
\footnote{216. \textit{Id.} (citing \textit{Barnes v. Osofsky}, 373 F.2d 269 (2d Cir. 1967) (interpreting the same “such security” language under § 11 of the 1933 Act); \textit{Unicorn Field, Inc. v. Cannon Group, Inc.}, 60 F.R.D. 217, 226 (S.D.N.Y. 1973); \textit{Colonial Realty Corp. v. Brunswick Corp.}, 257 F. Supp. 875, 879 (S.D.N.Y. 1966)).}
\footnote{217. 373 F.2d 269.}
\footnote{218. Indeed, courts may impose § 12(1) liability for the complete failure to register or for defective or incomplete attempts to register. The classic situation for § 12(1) liability involves complete failure to register coupled with the seller’s failure to perfect all of the terms of the relevant exemption. \textit{See}, e.g., \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119 (1953).}
\footnote{219. \textit{Gross}, 431 F. Supp. at 1095 (emphasis added).}
ated classes of section 11 defendants to encourage their conscientious preparation of the required disclosure documents, thereby enhancing the otherwise applicable common law standard of care. Because the scope of potential personal liability was enormous, the court in *Barnes* thought it was obligated to adhere strictly to the language of the statute and narrowly construed “such security” as used in section 11 to refer to the specific units offered under a materially defective registration statement. Consequently, the court’s interpretation in *Barnes* of the phrase “such security” as used in section 11 is consistent with the other subsections of section 11 dealing with, inter alia, defendants’ due diligence and potential liability exposure. The logic and force of this interpretation, however, does not carry over to section 12(2) because no similar consciousness-raising policy underlies section 12(2)’s fraud prohibition. In section 12(2), Congress was concerned with providing plaintiffs an improved remedy—over the common law counterpart—to redress fraudulent communications, whether written or oral.

Moreover, the courts construing the phrase “such security” as used in section 12(2) by analogizing to a line of authority interpreting the same phrase in section 11 simply misapprehended the portent of those cases. Those section 11 cases did not construe a phrase referring to distribution transactions, but rather one modifying the concept of a “registered” offering. It is quite different to infer from this linear privity requirement a congressional intent to limit section 12(2) liability to only those transactions occurring in the distribution markets. This Article suggests

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220. *Barnes*, 373 F.2d at 272.
221. See supra note 206 and accompanying text.
222. Moreover, some policy justification may exist for so interpreting § 11, in light of the “in terrorem” effect that Congress intended § 11 to have. See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. dened*, 397 U.S. 913 (1970).

The difference in the amount of damages recoverable under § 11 versus § 12(2) tends to show the different focus of § 11 versus § 12 liability: § 11 damages should reinforce the “in terrorem” effect of § 11 liability and encourage due diligence on the part of § 11 defendants, whereas Congress intended § 12(2) to remedy fraud, whether or not in the context of initial distribution. Within the context of public offerings, therefore, § 12(2) liability is the exclusive fraud remedy against a selling group member, but its application may extend beyond distribution markets. Otherwise, why would Congress draft such a broad remedy as § 12(2) if it intended to address only a narrow window of fraud, that is, fraud perpetuated by way of a “prospectus” in the sense of a § 10 prospectus used during the course of a registered public offering? See supra notes 170-71 and accompanying text for a discussion regarding the definition of a “prospectus.” In addition, the actual language of § 12(2) does not limit a suit brought pursuant to § 12(2) to transactions in the distribution market, as opposed to the trading market. Consequently, using the phrase “such security” to impose judicially such a limitation on the availability of this cause of action is entirely inappropriate.
instead that by adding section 12(2), Congress made clear its intent to eliminate fraud altogether by modifying common law remedies so as to ease a plaintiff's burden of proof. This relaxation, however, brought with it a carefully crafted set of procedural restrictions. Congress created a delicate balance, but in so doing made no reference to "distribution" versus "trading" transactions. As a result, courts should allow any defrauded buyer who otherwise satisfies the statutory requirements to pursue a section 12(2) claim.

III. CONCLUSION

Several courts have expressed disbelief that no federal appellate court has yet squarely addressed the question of whether section 12(2) liability extends to postdistribution trading.\(^{223}\) This Article, however, demonstrates that the lack of such courts of appeals decisions is not surprising because of the general understanding that section 12 was available to any defrauded buyer, whether in a distribution or a trading transaction, who otherwise satisfied the requisite elements of this express cause of action. This Article has attempted to focus attention on that which has long been well accepted: section 12(2) liability extends to fraudulent transactions in the trading markets as well as in the distribution markets.

It is disturbing that this recent line of cases has called into question a heretofore established premise under the 1933 Act: the section 12(2) remedy is available to the defrauded buyer in the context of both the distribution and the trading markets.\(^ {224}\) Courts should make clear that this defensive strategy of claiming otherwise is unavailable and that any defrauded buyer who can satisfy the statute's requirements may properly pursue a section 12(2) claim.

\(^{223}\) See, e.g., Mix v. E.F. Hutton & Co., 720 F. Supp. 8, 11 n.3 (D.D.C. 1989). As this Article was going to press, the Third Circuit Court of Appeals became the first appellate court to decide this issue. See supra note 7.

\(^{224}\) See supra note 6 and the cases collected therein (allowing plaintiffs to proceed with § 12(2) causes of action for fraud in secondary market transactions). These courts never questioned the availability of this express remedy to the defrauded secondary market buyer.