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DERIVATIVE LIABILITY IN SECURITIES LAW: CONTROLLING PERSON LIABILITY, RESPONDEAT SUPERIOR, AND AIDING AND ABETTING

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As with many areas of securities law, the issue of vicarious or derivative liability blends together a number of related statutory and common law elements. Although the various elements are related closely, this relationship has not contributed to the coherence of the principles applied. This article, therefore, seeks to provide an overview of the manner in which judicial and administrative decisions have balanced Congressional intent with the common law in the areas of controlling person liability, respondeat superior, and liability for aiding and abetting.

I. STATUTORY LIABILITY OF CONTROLLING PERSONS

Dating to their original enactment, the Securities Act of 1933¹ (1933 Act) and the Securities Exchange Act of 1934² (1934 Act) have included provisions imposing liability on persons who were not the primary actors in an illegal course of conduct, but who stood in a control relationship to the primary actor.³ Section 15 of the 1933 Act provides that persons in a control relationship with persons liable under section 11 or 12, will be liable if the controlling person had knowledge or reason to believe in the existence of the facts constituting the violation.⁴ Section 20(a) of the

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¹ 15 U.S.C. §§ 77a-77bbb (1976).

² 15 U.S.C. §§ 78a-78ll (1976).

³ See *infra* note 4. The principle of control may serve as the basis of secondary liability under other provisions of the securities laws. See, e.g., Investment Company Act, § 48(a), 15 U.S.C. § 80a-47(a)(1976) (unlawful for any person directly or indirectly to cause to be done any acts which would be unlawful for such person to do under Act); see also *Jerozal v. Cash Reserve Management, Inc.*, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,019, at 94,826 (S.D.N.Y. 1982).

⁴ See 15 U.S.C. § 770 (1976). Section 15 provides liability for any person: who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11, or 12

1934 Act provides liability for any controlling person unless that controlling person acted in good faith and did not induce the violation.⁵

As enacted in 1934, section 15 contained no defense to liability.⁶ The concept of controlling persons originated in the Senate version of what became the 1933 Act. The Senate bill contained the so-called "dummy provision" in which the Senate intended to prevent directors from evading liability for signing a registration statement by such means as appointing "dummy" directors who actually serve on the board.⁷ The House bill contained no similar provisions.⁸ The Conference Committee report described the Senate bill provisions as designed to make liability dependent upon the actual control exercised by one party over another irrespective of a direct agency relationship.⁹ The Conference report stated that the Senate provisions were merged into one and incorporated as a new section.¹⁰

When originally introduced, both the House and Senate bills, which were the principal vehicles leading to the enactment of the 1934 Act, also included provisions imposing liability on controlling persons without providing any defense.¹¹ Revised versions of these bills introduced one and two months later included the good faith defense which Congress ultimately enacted.¹² The Committee reports accompanying these bills did not explain the reason for, or intended effect of, the proposed addition.¹³ In response to criticism on the House floor that the concept of control was too vague, however, one Congressman stated that the object of the provi-

Id.

Section 11 of the 1933 Act generally imposes civil liability for false or misleading statements in a registration statement. *Id.* § 77k. Section 12 of the 1933 Act, generally imposes civil liability for the offer or sale of a security in violation of the registration and prospectus delivery requirements of § 5 of the Act, or by means of a false or misleading prospectus or oral communication. *See id.* §§ 771, 772.

Since secondary liability under § 15 is limited to violations of § 11 and § 12 of the 1933 Act, the majority of cases brought in this area allege violations of § 20(a) of the 1934 Act, which includes secondary liability for violations of the broad antifraud provisions of § 10(b) and rule 10b-5. *See id.* § 78t.

⁵ *See* 15 U.S.C. § 78t (1976). The Sixth Circuit has held that the SEC may not rely on § 20(a) in an injunctive enforcement action, but must rely on § 20(b), because the SEC is not a person to whom § 20(a)'s remedy runs. *See SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *But see SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973). The authority of the Sixth Circuit's position is subject to question in view of the 1975 amendment of the statutory definition of "person" in § 3(a)(9) to include a government or government subdivision, agency or instrumentality. *See Securities Act Amendments of 1975*, 89 Stat. 97, § 3(2) (June 4, 1975).

⁶ *See Securities Act of 1933*, Pub. L. No. 22, § 15, 48 Stat. 84 (1934) (current version at 15 U.S.C. § 77o (1976)).

⁷ S. 875, 73d Cong., 1st Sess. §§ 2(k), 4, 13 (1933); *see* S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933).

⁸ H.R. 5480, 73d Cong., 1st Sess. (1933).

⁹ H.R. CONF. REP. 152, 73d Cong., 1st Sess. 27 (1933).

¹⁰ *Id.*

¹¹ *See* S. 2693, 73d Cong., 2d Sess. (1934); H.R. 7852, 73d Cong., 2d Sess. (1934).

¹² *See* S. 3420, 73d Cong., 2d Sess. (1934); H.R. 9323, 73d Cong., 2d Sess. (1934).

¹³ *See* S. REP. NO. 792, 73d Cong., 2d Sess. (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934).

sion was to catch the man who stands behind the scenes and controls the man who is in a nominal position of authority.¹⁴

At the time of the adoption of the 1934 Act, Congress also amended the 1933 Act, including the addition of the "no knowledge" or "reasonable ground" defense to section 15.¹⁵ Congress intended this change to carry out more accurately the real purpose of section 15 by restricting the scope of the section. The mere existence of control is not a basis for liability unless that control is exercised effectively to bring about the action upon which liability is based.¹⁶ This correction of section 15 and the addition of the defense to section 20(a) were only two responses to the tremendous criticism and industry lobbying campaign that the proposed 1934 Act inspired.¹⁷

A. Definition of Controlling Person

The threshold question in interpreting section 15 and 20(a) is in determining who is a controlling person. Section 15 refers to every person who controls by or through stock ownership, agency, or otherwise, whereas section 20(a) speaks of every person who controls directly or indirectly. Notwithstanding these differences in language, it frequently is acknowledged that section 20(a) was modeled on section 15, and courts have tended to interpret these sections analogously.¹⁸ While both statutes define "person" broadly to include an individual, an organization, or a group, Congress declined to define the term "control", apparently concluding that the concept of control must remain flexible.¹⁹ Consistent with this intent, the courts have construed "control" broadly²⁰ and have imposed few limita-

¹⁴ See 77 CONG. REC. 8306 (1934). Congressman Lea stated that the man charged with control would be liable only to the extent the controlling person did control the action complained of. *Id.*

¹⁵ Pub. L. No. 291, § 208, 48 Stat. 908 (1934).

¹⁶ H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934).

¹⁷ See 77 CONG. REC. 8924 (1934). Upon beginning hearings on the revised House bill, Congressman Rayburn noted that in the new draft the Committee had tried to meet the legitimate criticism to which the prior draft had been subjected. *Stock Exchange Regulation Hearings, House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 625 (1934) (remarks of Chairman Rayburn). Similarly, upon offering the proposed amendments to the 1933 Act as Title II to the 1934 Act bill on the Senate floor, Senator Fletcher, Chairman of the Senate Committee on Banking and Currency, stated that the purpose of the amendment was to clarify and liberalize the Securities Act and to relieve the Act of some ambiguities. 77 CONG. REC. 8924 (1934).

¹⁸ See, e.g., *Pharo v. Smith*, 621 F.2d 656, 673 (5th Cir. 1980); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).

¹⁹ See H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934). The House report accompanying the 1934 Act states that the term "control" is intended to include actual control and legally enforceable control. The House report, although not defining the term, lists as examples of methods of control used, stock ownership, lease, contract and agency. *Id.*

²⁰ A number of courts have looked for guidance to, without necessarily relying upon, the definition of "control" promulgated by the SEC for purposes of certain reports required to be filed under the 1934 Act. See 17 C.F.R. § 240.12b-2(f) (1982).

tions on the categories of persons who may meet the standard of controlling person status in particular fact situations.²¹

Based on the case law, difficulty exists in defining the entire class of persons who may be controlling persons. Some commentators have observed that the courts have applied two distinct standards of control.²² According to these authorities, some courts have found "control by status" based primarily on the person's position of control within an organization, with little regard to the exercise of control. Other courts have required a showing of both a certain status and the exercise of control by the controlling person. In many cases, however, the analysis of this issue is not articulated fully, and the distinction between matters relevant to who is a controlling person and to whether the controlling person has established a defense to liability may not be drawn clearly.²³ The better reasoned cases separate the issue of control from the issue of whether the defendant's conduct meets the statutory defense. These cases treat the issue of control as a question of fact to be determined on the basis of all the circumstances.

For purposes of establishing who is a controlling person, it should not be necessary that the controlling person actually exercised control over the particular transaction giving rise to the violation.²⁴ In the majority of cases, the courts have given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise of power,²⁵ and one may be a controlling person even if one has only some indirect means of discipline or influence short

²¹ Courts have held, however, that a national securities exchange cannot be liable as a "controlling person." See, e.g., *Carr v. Nyse*, 414 F. Supp. 1292 (N.D. Cal. 1976).

²² See, e.g., Marshall, *Control Person Liability*, 13 REV. SEC. REG. 927 (1980); Johnston, *Vicarious Liability of Controlling Persons Under the Securities Acts*, 11 LOY. L.A.L. REV. 151 (1977); Note, *Liability of Corporate Directors as "Controlling Persons" Under Section 20(a) of the Securities Exchange Act*, 28 DRAKE L. REV. 437 (1978-79); Note, *Liability of Controlling Persons—Common Law and Statutory Theories of Secondary Liability*, 24 DRAKE L. REV. 621, 630-31 (1975); Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019 (1973).

²³ See, e.g., *Moerman v. Zipco, Inc.*, 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970). Some cases frequently cited as evidence of the "control by status" doctrine, when read as a whole, do not support clearly the dichotomy. See, e.g., *Harriman v. E.I. DuPont de Nemours & Co.*, 372 F. Supp. 101, 104-05 (D. Del. 1974) (finding allegation of status that involves potential for control sufficient to state cause of action since participation of defendant in alleged violations is relevant only to controlling person's defense); *Moerman v. Zipco, Inc.*, 302 F. Supp. at 439 (following discussions of specific involvement of defendants in operations of company, concluding that persons who act as directors are in control of corporation); but see *SEC v. First Sec. Co.*, 463 F.2d 981 (7th Cir.) (finding securities firm liable, inter alia, as controlling person of president and owner of 92% of corporation's stock), *cert. denied*, 409 U.S. 880 (1972). See also *Camrose Inc. v. Intervester U.S. Real Estate Fund*, [1975-76 Transfer Binder] FED. SEC. L. REP. ¶ 95,469 at 99,376 (S.D.N.Y. 1976).

²⁴ See, e.g., *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 823-24 (E.D. Wis. 1977).

²⁵ See *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 538 (D. Md. 1978); *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976).

of actual direction over the controlled person.²⁶

While a great many cases alleging control person liability have arisen in the context of an employer-employee relationship,²⁷ general agreement exists among the courts that the means of control need not derive from traditional employer-employee, principal-agent or master-servant relationships,²⁸ or even from stock ownership of the controlled person.²⁹ The means of control may arise through business relationships other than stock ownership, through interlocking directorates, family relationships, and through a myriad of other factors. In addition, the controlling person need not be the only person or entity with direct means of discipline or influence.³⁰

Thus, a brokerage firm may be liable for securities violations of an investment adviser placed on the firm's approved list.³¹ As a controlling person of the corporation, an officer or director may be liable for acts of other corporate agents.³² In addition, the intended beneficiary of stock purchases may be liable for securities violations committed by the person purchasing stock on his behalf.³³

B. Defense to Controlling Person Liability

Although the courts' liberal construction of control encompasses a broad spectrum of defendants, controlling persons still may avoid secondary liability by meeting the defenses provided in sections 15 and 20(a). To meet the statutory defense provided by section 15, the controlling per-

²⁶ See *SEC v. First Sec. Co.*, 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); *Richardson v. MacArthur*, 451 F.2d 35, 41-42 (10th Cir. 1971); *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

²⁷ See, e.g., *Henricksen v. Henricksen*, 640 F.2d 880, 884 (7th Cir.) (brokerage firm for registered representative), *cert. denied*, 454 U.S. 1097 (1981); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 179 (3d Cir. 1981) (accounting firm for its accountants), *cert. denied*, 455 U.S. 938 (1982); *Paul F. Newton & Co. v. Texas Commerce Bank*, 639 F.2d 705, 712 (2d Cir.) (brokerage firm for registered representative), *cert. denied*, 499 U.S. 1011 (1980); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir.) (newspaper published for financial columnist), *cert. denied*, 423 U.S. 1025 (1975). *But see Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665, 669 (9th Cir. 1978) (brokerage firm did not control account executive in his capacity as guardian of estate); *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d at 891 (finding president controlling person of company and rejecting argument that company was controlling person because president and company cannot simultaneously be controlling persons as to each other); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (corporation for its director); *Richardson v. MacArthur*, 451 F.2d at 41 (corporation for agent hired to develop company in another state).

²⁸ See *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388, 394 (4th Cir. 1979), *cert. denied*, *Carpenter v. Edwards & Warren*, 444 U.S. 868 (1979); *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949).

²⁹ See *Harriman v. E.I. DuPont de Nemours & Co.*, 372 F. Supp. 101, 105 (D. Del. 1974).

³⁰ *Id.*

³¹ See *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 538-39 (D. Md. 1978). *But see Nelson v. Hench*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,085 at 91,906 (D. Minn. 1977).

³² See, e.g., *G.A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981).

³³ See *Myzel v. Fields*, 386 F.2d 718, 738-39 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

son must show that he had no knowledge of, or reasonable ground to believe in, the existence of the facts constituting the primary violation. To avoid liability under section 20(a), the controlling person must show that he acted in good faith and did not directly or indirectly induce the acts constituting the violations.³⁴

As noted above, little explanation can be offered for the difference in the language used in sections 15 and 20(a) to articulate the controlling person's defense, even though the defense to section 15 liability was first added by an amendment contained in the bill which Congress adopted as the 1934 Act.³⁵ In any case, court decisions appear to give little consideration to these variations in language, and tend to characterize both provisions as good faith defenses.

C. *Good Faith Versus Knowledge*

As a matter of literal interpretation, the differences between the two provisions may not be as significant as they appear on their face, because the concepts of knowledge and good faith may overlap to a considerable extent and may involve similar kinds of proof. Thus, the term "good faith" has been defined as "honesty of intention, and freedom from knowledge of circumstances which ought to put the [person] on inquiry."³⁶ This definition suggests some basis for construing the two provisions similarly.

As indicated by the earlier discussion of the legislative history of sections 15 and 20(a), Congress did not address directly the degree of culpability upon which it intended to base liability under these sections. Some courts, in interpreting both these provisions, have looked to the legislative history of section 11 of the 1933 Act,³⁷ apparently reasoning that Con-

³⁴ Most courts hold that the defendant bears the burden of establishing these defenses. *See, e.g.,* G.A. Thompson & Co., Inc., v. Partridge, 636 F.2d at 958. Whether the burden of showing lack of good will would fall on the plaintiff in circuits that require proof of the defendant's "culpable participation" is unclear. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175, 185 (3d Cir. 1981).

³⁵ *See* Securities Exchange Act of 1934, Pub. L. No. 291, § 208, 18 Stat. 881, 908 (1934).

³⁶ *See* BLACK'S LAW DICTIONARY 623 (5th ed. 1979). A more significant difference would appear to be the inducement language present in § 20(a) but not in § 15. Little authority exists that discusses what constitutes inducing a violation under section 20(a). *But see* Myzel v. Fields, 386 F.2d at 738 (intended beneficiary of unlawful stock purchase need not have knowledge of agent's specific wrongdoing, only directly or indirectly induce the purchase). Arguably, some conduct that would evidence a lack of good faith, such as the failure of a controlling person with knowledge of wrongdoing by the controlled person to take corrective action, also could support a theory of "indirect" inducement.

In other contexts, the term inducement has referred to some causal relationship between a person's influence on another and the acts constituting the violation. *See, e.g.,* Fromberg, Inc. v. Thornhill, 315 F.2d 407, 411 (5th Cir. 1963) (patent infringement) (inducement connotes active steps knowingly taken in contrast to accidental or inadvertent action); BLACK'S LAW DICTIONARY 9815 (5th ed. 1979). Conduct which would evidence such "direct" inducement would approach conduct supporting an aiding and abetting theory.

³⁷ *See* Christoffel v. E.F. Hutton & Co., Inc., 588 F.2d 665 (9th Cir. 1978); Rochez Brothers, Inc. v. Rhoades, 527 F.2d at 885. These courts do not distinguish between the legislative history of § 15 and that of § 11. *See* Christoffel v. E.F. Hutton & Co., Inc., 588 F.2d at 668;

gress would have intended that the standards adopted in that section apply to persons attempting to evade the requirements of section 11 or section 12. These courts point out that Congress adopted the House bill's fiduciary standard of due care, rather than the insurer's liability standard which the Senate bill would have imposed.³⁸ The significance of this legislative history in this regard, however, is subject to question.³⁹

D. *Majority Rule: Duty to Supervise Controls Good Faith*

The majority of circuits have held that a controlling person's failure to take precautionary measures to prevent an injury caused by the controlled person may vitiate the good faith defense. Brokerage firms have been held to a stringent standard of good faith, and must show that they had established, maintained, and diligently enforced a proper system of supervision and control over their employees to make out a defense to liability.⁴⁰ This duty to supervise is supported by such public policy considerations as the fact that employees of brokerage firms face ever-present opportunities and temptations to take advantage of clients, and that brokerage firms, which stand to benefit from violations, are in the best position to prevent such conduct.⁴¹

On the other hand, in cases involving controlling persons other than brokerage firms, courts have tended to apply a less rigorous test of good faith. Generally, the test of whether the controlling person has done enough

Rochez Brothers, Inc. v. Rhoades, 527 F.2d at 885; *see also* *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980).

³⁸ *See* *Christoffel v. E.F. Hutton & Co.*, 588 F.2d at 665; *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d at 885. The Senate bill would have rendered an issuer, its directors, chief executive officer and financial officers strictly liable for the return of any compensation paid for shares sold by means of a materially false or misleading registration statement. *See* S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933). The House version, while imposing strict liability on the issuer, generally provides a due care defense to corporate directors, and to the rest of the broader class of professionals subjected to liability under that section. *See* H. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933). The Conference Committee adopted the House's fiduciary standard, along with the concept of extended liability embodied in the Conference Committee's version of the Senate's dummy provisions. *See* H. CONF. REP. 73d Cong., 1st Sess. 27 (1933).

The argument may be made that the "no knowledge" and "reasonable guard" defense that Congress added to § 15 in 1934 was intended to conform the scope of liability under that section to that in § 11. But the assumption that the Congress had chosen carefully the language used would require that a different analysis obtain in the case of § 20(a), which contains a "good faith" defense and, in any case, creates potential liability in connection with a wide range of primary violations of the 1934 Act. More importantly, even if applicable this legislative history really does not resolve the difficult issue of what degree of culpability Congress intended to apply under the controlling person provisions.

³⁹ *See supra* note 38.

⁴⁰ *See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d at 1120; *Henricksen v. Henricksen*, 640 F.2d 880, 884 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438-39 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

⁴¹ *See, e.g., Zweig v. Hearst Corp.*, 521 F.2d 1129, 1135 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Lorenz v. Watson*, 258 F. Supp. 724, 733 (E.D. Pa. 1966).

to prevent the violation depends on what he could have done under the circumstances.⁴² Thus, courts have held that the practicalities of operating a daily newspaper dictate that, in the absence of some notice of impropriety, a newspaper publisher can rely on its reporters to discharge its requirements to report fairly and accurately, and thereby establish a good faith defense.⁴³ Similarly, courts have recognized that directors cannot be expected to exercise the kind of supervision over a corporate president that brokers must exercise over salesmen.⁴⁴

*E. Minority View: Controlling Person Liability
Depends on Culpability*

In contrast, the Second and Third Circuits repeatedly have held, at least with respect to section 20(a), that the intent of this provision is to impose liability only on persons who are in some meaningful sense culpable participants in the wrongdoing perpetrated by the controlled person.⁴⁵ Under this view, liability may be based on the inaction or silence of a controlling person only if the plaintiff shows that the inaction or silence was deliberate and done intentionally to further the fraud.⁴⁶ However, even under this view, it appears that brokerage firms may be liable for failure to meet their duty to supervise.⁴⁷ Cases decided by the Fourth and Ninth Circuits have also suggested some kind of culpability requirement.⁴⁸

As suggested above, it is unclear whether the precautionary measures or the culpable participation standard of good faith more closely reflects the legislative intent behind the controlling person provision. Moreover, the effect of the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*⁴⁹

⁴² See *G.A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981).

⁴³ See *Zwieg v. Hearst*, 521 F.2d at 1129.

⁴⁴ See *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969); see also *Richardson v. MacArthur*, 451 F.2d 35, 42 (10th Cir. 1971) (incumbent on corporation to adopt some precautionary measures or internal controls in view of SEC investigation and broad authority corporation granted agent in another state).

⁴⁵ See *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981); *Rochez Brothers Inc. v. Rhoades*, 527 F.2d at 884; *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d at 1299.

⁴⁶ See *Sharp v. Coopers & Lybrand*, 649 F.2d at 185.

⁴⁷ See *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); *Moss v. Morgan Stanley, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,045 at 94,979 (S.D.N.Y. 1983), app. pending, Civ. Section No. 83-7120 (2d Cir.).

⁴⁸ See *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388, 394 (4th Cir. 1979), cert. denied, *Carpenter v. Edwards & Warren*, 444 U.S. 868 (1979); *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978) (refusing to extend secondary liability for mere inaction); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1210 (9th Cir. 1970) (controlling person must have acted in bad faith and directly or indirectly induced conduct complained of).

⁴⁹ 425 U.S. 185 (1976). In *Hochfelder*, the Supreme Court dismissed an action against an accounting firm which allegedly had aided and abetted the fraud of an employee of a brokerage firm by negligently failing to discover the fraud in the course of its audit of

on existing law interpreting sections 15 and 20(a), is also not certain. In *Hochfelder*, the Court noted that section 15 allows recovery for negligent conduct,⁵⁰ whereas section 20(a) is one of those provisions which contains a state-of-mind condition requiring something more than negligence.⁵¹ With respect to section 15, this suggests that the lesser standard is the more appropriate. With respect to section 20(a), however, the question may remain unresolved. The Court's holding may appear to require the culpable participation standard. But since the Court did not indicate how much more culpability than negligence is required for liability, it is possible that the culpable participation standard imposes too high a threshold. While the failure to supervise standard might appear to be a negligence standard which the Court would reject, a number of broker-dealer cases suggest that the failure to supervise adequately may rise to the level of reckless conduct,⁵² or even participation in the violation⁵³ and therefore may satisfy the Supreme Court's state-of-mind requirement.

II. THE DOCTRINE OF RESPONDEAT SUPERIOR

The relevance of common law doctrines such as respondeat superior to the federal securities laws arises from the principle that the federal courts may look to such common law doctrines to enforce federally created rights, where such remedies are necessary to effectuate the congressional policy embodied in the federal statute creating those rights. As the Supreme Court has observed with respect to the federal securities laws, Congress generally enacted these statutes against the background of existing state law, and that merely because a plaintiff's securities claim is based upon a federal statute does not mean that Congress intended the entire corpus of existing law to be replaced.⁵⁴

The Supreme Court has not yet considered the applicability of respondeat superior to the federal securities laws, but the Court has approved reliance on common law agency principles, including respondeat superior, in fashioning remedies under a wide variety of other federal remedial statutes.⁵⁵ In looking to these principles for guidance, however,

the firm. The Court held that proof of scienter is a necessary element of a cause of action under § 10(b) of the 1934 Act, as well as under rule 10b-5. The Court reserved the issue of whether reckless conduct may satisfy this requirement. *See id.* at 194 n.12.

⁵⁰ *Id.* at 205-26, n.27 (1976).

⁵¹ *Id.* at 209 n.28 (1976).

⁵² *See* G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 959-60 (5th Cir. 1981); Carpenter v. Harris, Upham & Co., Inc., 594 F.2d at 388.

⁵³ *See* Henricksen v. Henricksen, 640 F.2d 880, 885 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); SEC v. First Securities Co., 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

⁵⁴ *See* Burks v. Lasker, 441 U.S. 471, 478 (1979).

⁵⁵ *See* American Soc. of Mechanical Eng'rs v. Hydrolevel Corp., 456 U.S. 556, 565-66 (1982) (antitrust laws); United States v. A&P Trucking Co., 358 U.S. 121, 125 (1958) (transportation); Gleason v. Seaboard Air Line R. Co., 278 U.S. 349, 356-57 (1929).

the Court has emphasized that the imposition of liability based on common-law principles must be consistent with the Congressional intent behind the statute.⁵⁶

In recent years, most of the federal courts of appeal have had occasion to consider whether the application of the principle of respondeat superior is consistent with the purposes of the federal securities laws, most frequently in connection with allegations of fraud under section 10(b) of the 1934 Act and rule 10b-5. In these cases, questions have been raised as to the proper relationship between respondeat superior and section 15 of the 1933 Act and section 20(a) of the 1934 Act, the controlling person provisions.

As discussed more fully in the previous section of this article, the controlling person provisions impose liability on a broad class of persons who possess, through an agency relationship or otherwise, some direct or indirect control or influence over persons who violate the securities laws, but only if those persons fail to meet the requisite lack of knowledge or good faith defenses provided in those provisions. By contrast, the common law doctrine of respondeat superior imposes secondary liability on a more limited category consisting of employers or other principals for certain wrongful acts committed by an employee or other agent, but liability will attach even though they did not intend or direct these wrongful acts.⁵⁷ Under this doctrine, an employer may be liable for a tort committed by an employee while acting within the scope of his employment,⁵⁸ or for false or misleading representations made by an employee with actual or apparent authority to make them.⁵⁹ The doctrine, however, is not grounded on the employer's negligence or failure to supervise, and thus such defenses to liability as the employer's good faith or due diligence are not available.⁶⁰

A. *Policy Basis for Strict Liability Under Respondeat Superior*

Historically, a variety of rationales has been advanced to support the imposition of strict liability under the doctrine of respondeat superior. The principal justification is that the employer controls the acts of his

⁵⁶ See *American Society of Mechanical Eng'rs v. Hydrolevel Corp.*, 456 U.S. at 568-69, n.6 (1982).

⁵⁷ See SEAVEY, *Speculations as to "Respondeat Superior"*, 1934 HARVARD LEGAL ESSAYS 433 (1934); W. BLACKSTONE, COMMENTARIES 431.

⁵⁸ RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958).

⁵⁹ *Id.* § 257, 261 (1958).

⁶⁰ See 3 AM. JUR. 2D *Agency* § 261 (1962). As a doctrine of secondary liability, respondeat superior is conceptually distinct from common law theories of primary liability. For example, a principal may be primarily liable for the act of an agent where he intentionally causes the act to be performed. See RESTATEMENT (SECOND) OF AGENCY § 212 (1958). A principal also may be liable primarily where he is reckless in giving orders, in employing agents or in supervising the activity of agents. *Id.* at § 213. In practice, however, the conceptual distinctions between respondeat superior and other principles of agency law may be difficult to apply.

employee.⁶¹ The employer hires the employee, expects to profit from his conduct, and so should bear the burden if his conduct is wrongful.⁶² Additionally, the employer places in the employee's hands the means to commit the wrong⁶³ and the employer should be given the incentive to conduct his business safely.⁶⁴ A modern justification frequently given is that the doctrine represents a policy determination to allocate the risk of loss to the employer, rather than to the innocent victim of the employee's misconduct, since the employer can absorb the monetary loss as a cost of doing business.⁶⁵

B. *Interplay Between Controlling Person and Respondeat Superior Doctrines*

Since the scope of the controlling person provisions is clearly broad enough to encompass the employer-employee type relation, which is the subject of respondeat superior, the question has arisen whether the inclusion in these sections of defenses to liability reflects the Congressional intent to supplant this common law doctrine. A majority of circuits has taken the position that the controlling person provisions were not intended to preempt the doctrine of respondeat superior or otherwise to constitute the exclusive means for imposing secondary liability under the federal securities laws.⁶⁶ The rationale generally underlying this position is that, notwithstanding any apparent ambiguities in their language or legislative history, the controlling person provisions fundamentally were intended

⁶¹ See PROSSER, *THE LAW OF TORTS*, 459 (4th ed. 1971); 3 AM. JUR. 2D *Agency* § 261 text at nn.1&2 (1962).

⁶² 3 AM. JUR. 2D *Agency* § 261 at nn.1 & 2 (1962); see 53 AM. JUR. 2D, *Master and Servant* § 417 (1970).

⁶³ See PROSSER, *THE LAW OF TORTS*, 459 (4th Ed. 1971); 3 AM. JUR. 2D *Agency* § 261 at nn.1&2 (1962).

⁶⁴ See SEAVEY, *supra* note 57, at 447.

⁶⁵ See PROSSER, *THE LAW OF TORTS*, 459 (4th ed. 1971); Douglas, *Vicarious Liability and Administration of Risk II*, 38 YALE L.J. 720, 722 (1929); SEAVEY, *supra* note 57, at 450.

⁶⁶ See, e.g., *Henricksen v. Henricksen*, 640 F.2d 880, 887 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 712 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1980); *Holloway v. Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 741 (10th Cir. 1974).

The authorities uniformly have interpreted the Fourth Circuit decisions to concur that the remedies under respondeat superior and the controlling person provisions co-exist. See *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974). However, a recent district court opinion has interpreted the Fourth Circuit's position to be that the controlling person provisions provide an exclusive remedy. See *Haynes v. Strudwick, Inc.*, 508 F. Supp. 1303, 1311-13 (E.D. Va. 1981). The district court relied on the Fourth Circuit's decision in *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388, 393 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), which did not address the applicability of respondeat superior, but that held that to impose liability on a brokerage firm under the controlling person provisions, some culpable participation must be found within the firm. In the *Carpenter* case, however, the plaintiff sought

to expand, rather than restrict, the scope of liability under the securities laws. As discussed below, however, at least two circuits have reached the opposite or more restrictive conclusions regarding the applicability of respondeat superior to claims under securities laws.

Most courts which have concluded that respondeat superior has continued vitality under the securities laws have done so without providing extensive analysis. The most complete statement in support of this conclusion has been made by the SEC.

C. *Availability of Controlling Person Defenses to
Employers Subject to Respondeat Superior*

In *Sharp v. Coopers & Lybrand*,⁶⁷ the SEC recently argued an *amicus curiae* brief that Congress did not intend the controlling person provisions to limit the traditional responsibility of an employer for the acts of employees, but rather intended to supplement traditional agency principles to cover certain situations in which no agency relationship existed between the defendant and the person who performed the prohibited acts.⁶⁸ In this context, the SEC argued that no inconsistency exists in Congress' providing such persons with statutory defenses not available in the common-law employer-employee context. But to permit an employer to assert these statutory defenses, and thus constrict the protection available to investors under federal securities laws compared with the pre-existing common law, would be inconsistent with the Congressional purpose to expand the basis for secondary liability.

A few courts that have considered respondeat superior claims have shared the SEC's view after reviewing the legislative history of the controlling person provisions.⁶⁹ Other courts, relying apparently on the

to hold a brokerage firm liable for the conduct of its registered representative occurring after the representative left the employment of the firm. *Id.* at 394-95.

See also *Holmes v. Bateson*, 583 F.2d 542, 560-61 (1st Cir. 1978); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 214 (D. Mass. 1978); *Myzel v. Fields*, 386 F.2d 718, 737-39 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

⁶⁷ See, e.g., Brief of the Securities and Exchange Commission, *amicus curiae*, *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981) (private damage action), *cert. denied*, 455 U.S. 938 (1982); Brief of the Securities and Exchange Commission, *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975) (injunctive action); *In re Armstrong, Jones & Co.*, 43 SEC 888 (1968) (broker-dealer administrative proceeding), *aff'd*, *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir.) (broker-dealer administrative proceeding), *cert. denied*, 398 U.S. 958 (1970). A commentator has suggested that the entire controversy over respondeat superior can be traced back to a brief filed by the SEC as *amicus curiae* in *Paul H. Aschkar & Co. v. Kamen & Co.*, *cert. dismissed*, 393 U.S. 801 (1968). See Duggan, *The Brooding Omnipresence of the Federal Common Law: The Evisceration of the Controlling Person Provisions of the Federal Securities Acts*, 50 *FORDHAM L. REV.* 472, 476 n.23 (1981).

⁶⁸ See Brief of the Securities and Exchange Commission, *amicus curiae*, *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

⁶⁹ *Paul F. Newton & Co. v. Texas Commercial Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1980); *SEC v. Management Dynamics*, 515 F.2d 801, 812 (2d Cir. 1975); *Johns Hopkins Univ.*

remedial purposes of the securities laws as well as the practical consequences, have rejected a result in which the controlling persons provisions would shield employers from the responsibility they otherwise would bear for the acts of employees committed within the scope of their employment.⁷⁰

Of those courts which have recognized liability based on respondeat superior, only the Second Circuit seems to have had a difficult time in reaching the conclusion. Early decisions in that circuit appeared to reject the liability of respondeat superior under the securities laws.⁷¹ More recently, however, in *SEC v. Management Dynamics Inc.*,⁷² the Second Circuit held that section 20(a) was not intended to supplant the application of agency principles in securities cases, and found a corporation liable under the doctrine of respondeat superior for the actions of a principal executive officer using corporate facilities to create a misleading appearance of activity in a certain stock. Nevertheless, the court expressly stated that it offered no view as to cases involving minor employees, claims for damages, or respondeat superior that might be broader than the apparent authority involved in that case.⁷³

In *SEC v. Geon Industries, Inc.*,⁷⁴ the Second Circuit reaffirmed that a brokerage firm could be liable for an employee's actions under respondeat superior. The Second Circuit declined to enjoin the firm involved in that case after finding that the firm had exercised reasonable supervision over its registered representative, that the registered representative had made no special use of his connection with the firm, and that the firm had derived only ordinary commissions from the registered representative's activities. The court refused to extend its holding beyond the present factual situation and stated that any cases that may fall between *Management Dynamics* and *Geon Industries* would have to await future resolution.⁷⁵

Most recently, in *Marbury Management Inc. v. Kohn*,⁷⁶ the Second Circuit reviewed this history as well as the case law of the other circuits. In *Kohn*, which involved alleged misrepresentations by a trainee at a brokerage house regarding his status, the court remanded the case for consideration of the liability of the firm as a controlling person under section 20(a) and as a principal under the doctrine of respondeat superior.

v. Hutton, 297 F. Supp. 1165, 1212-13 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

⁷⁰ See *Marbury Management, Inc. v. Kohn*, 629 F.2d at 712.

⁷¹ See *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*en banc*); *Gordon v. Burr*, 366 F. Supp. 156, 167-68 (S.D.N.Y. 1973), *aff'd in part, rev'd in part*, 506 F.2d 1080, 1085 (2d Cir. 1974); *Moerman v. Zipco, Inc.*, 422 F.2d 871 (2d Cir. 1970); see also *SEC v. Lum's Inc.*, 365 F. Supp. 1046, 1064-65 (S.D.N.Y. 1973).

⁷² 515 F.2d 801, 812-13 (2d Cir. 1975).

⁷³ *Id.* at 813.

⁷⁴ 531 F.2d 39, 54-56 (2d Cir. 1976).

⁷⁵ *Id.* at 55-56.

⁷⁶ 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

The court suggested that the concern is simply with scope or course of employment and whether the acts of the employee fairly can be considered to be within the scope of his employment.⁷⁷ The court also noted that the good faith defense afforded by section 20(a) is not available on respondeat superior claims.⁷⁸

Summarizing its position on respondeat superior, the court stated quite broadly that no reason exists for believing that Congress intended section 20(a) to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles.⁷⁹ The *Kohn* court noted that section 28(a) specifically prescribes that rights and remedies provided by the 1934 Act shall be in addition to any and all rights and remedies that may exist at law or in equity. Furthermore, section 16 of the 1933 Act similarly provides that the rights and remedies of the 1933 Act are additional to pre-existing remedies.⁸⁰

D. Ninth Circuit View: Securities Law Supersedes Common Law

The Ninth Circuit, which has suggested it was the first circuit to address the issue, has adopted the rule that section 20(a) supplants vicarious liability of an employer under the doctrine of respondeat superior. In *Zweig v. Hearst Corp.*,⁸¹ the court relied on *Kamen & Co. v. Paul H. Aschkar & Co.*,⁸² the purported forerunner of cases on this issue, as controlling authority for this proposition. Unfortunately, however, the *Kamen* case did not discuss explicitly respondeat superior as a basis for liability under the securities laws.⁸³ Furthermore, while the Ninth Circuit has continued to adhere to its view on the exclusivity of the remedy afforded by section 20(a), none of its decisions has discussed the reasoning underlying this view.⁸⁴

The Third Circuit, while ostensibly following the minority rather than the majority view, has in reality adopted a novel, intermediate position. For example, in *Rochez Brothers Inc. v. Rhoades*,⁸⁵ the court reviewed the legislative history of the controlling person provisions and concluded that the use of respondeat superior for imposing secondary liability would not advance the legislative purpose of the 1934 Act and in fact, would under-

⁷⁷ *Id.* at 716.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

⁸² 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968).

⁸³ *See, e.g.*, *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980).

⁸⁴ *See Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978); *Douglas v. Glenn E. Hinton Inv., Inc.*, 440 F.2d 912 (9th Cir. 1971); *see also Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

⁸⁵ 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976).

mine the congressional intent by emasculating section 20(a).⁸⁶ Accordingly, the court adopted the rule that respondeat superior is not applicable to determine secondary liability in a securities case. In dictum, however, the court distinguished the situation in *Rochez*, in which the court found the corporation was not liable for the activities of corporate officers dealing in corporate stock for themselves and their own account, from the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist. This duty, the court noted, is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers.⁸⁷

In *Sharp v. Coopers & Lybrand*,⁸⁸ the Third Circuit reaffirmed the general rule that respondent superior is inapplicable to securities law cases. The court seized, however, upon the "broker-dealer exception" provided in the *Rochez* case, and applied it to an accounting firm. Following *Rochez*, therefore, the Third Circuit held the firm liable under respondent superior for misleading opinion letters issued in the firm's securities sales program. In reaching its decision, the court looked to the case law in other circuits. The court interpreted the Second Circuit's decision in *Marbury Management* as analogous to its own. The court noted that previous Second Circuit decisions had declined to apply respondeat superior in other contexts, and felt that the operative factor in *Marbury Management* was that it involved a brokerage firm. The court stated that the implied reasoning in *Marbury Management* that brokers have a higher public duty under securities laws than do other persons, leads to the imposition of a duty to exercise a high standard of supervision. This duty is enforceable through imposition of secondary liability based on respondeat superior.⁸⁹

The court read the case law of the other circuits from a similarly narrow perspective, noting that respondeat superior had been applied in cases involving high-level officers or directors, brokerage firms, or both. The court found these decisions consistent with its own, noting that many of these cases emphasized the inescapable public trust placed in the firms involved and the corresponding duty to supervise. The court found the same type of stringent duty to supervise in the case before it because Coopers & Lybrand had put itself in a position in which the investing public would place their trust and confidence.

Finally, the court suggested that the policy of protection of investors, which is the primary purpose of the securities laws, supported its decision. The court reasoned that respondeat superior must be applicable when a firm's public representations are designed to influence investors, otherwise, the firm could insulate itself from liability by construing a "Chinese wall" between employees and partners, depriving investors of the benefit

⁸⁶ *Id.* at 885.

⁸⁷ *Id.* at 886.

⁸⁸ 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

⁸⁹ *Id.* at 182.

of the greater expertise of these partners. However, in view of the many other important services which accounting firms perform, the court emphasized the limited scope of its holding.

The full reach of the exception to the rule that respondeat superior does not apply to securities cases in the Third Circuit is difficult to assess. In *Rochez*, the court found that Congress intended section 20(a) to be the exclusive means of imposing secondary liability. In *Sharp*, however, the same court emphasized strongly that the doctrine of respondeat superior, though applicable in *Sharp*, should not be expanded widely in the area of federal securities regulation.⁹⁰ Nonetheless, the court did expand its previous broker-dealer exception to another type of firm that the court found occupied a position of public trust. Significantly, the court also noted that application of the doctrine of respondent superior was not necessary to find a corporation liable for the actions of high level employees, because their action on behalf of the corporations would create primary liability on its part.⁹¹ One commentator has suggested that, for all practical purposes, the Third Circuit's exception has become the rule.⁹²

III. AIDING AND ABETTING

Another basis on which secondary liability has been imposed for violations of the securities laws on persons other than the primary actor is the theory of aiding and abetting. Two provisions of the securities laws expressly authorize actions based on an aiding and abetting theory,⁹³ however, the majority of cases employing this theory have arisen under other sections of the laws that do not address specifically the question.⁹⁴

The Supreme Court explicitly has reserved the question of the viability

⁹⁰ *Id.* at 183.

⁹¹ *Id.* at 182, n.8.

⁹² See Note, *Vicarious Liability: Respondeat Superior Applicable in Cases Involving High Fiduciary Duties Despite Controlling Persons Provision of Securities Exchange Act—Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), 12 SETON HALL 353, 366-67 (1982).

⁹³ See Securities Exchange Act of 1934 § 15(b)(4)(E), 15 U.S.C. § 77a-77bbbb (1976) (authorizing SEC to sanction broker-dealers for willful aiding or abetting of securities law violations); Investment Advisors Act of 1940 § 209(e), 15 U.S.C. § 80b-9(e) (1976) (authorizing SEC to bring action in federal court against any person aiding or abetting violation of Act); see also 18 U.S.C. § 2(a) (1976) (imposing criminal liability for aiding and abetting commission of offense against United States).

⁹⁴ In 1959, the SEC recommended that Congress amend the 1933 and 1934 Acts to include a provision expressly making it unlawful for any person to aid, abet, counsel, command, induce, or procure any violation of those acts. See *Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 275-76 (1959); *Hearings Before the House Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 93, 103 (1959). Congress did not adopt this amendment, regarding the amendment as an unnecessary codification of existing law. See S. REP. NO. 1757, 86th Cong., 2d Sess. 9 (1960); see also *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 677-80 (N.D. Ind. 1966), cert. denied, 397 U.S. 989 (1970).

of aiding and abetting under the securities laws.⁹⁵ The doctrine, however, has a long history in the lower courts. The courts apparently have assumed, albeit without discussion in most cases, that the securities laws were not intended to displace the aiding and abetting doctrine.⁹⁶ In fact, no lower court has rejected the applicability of aiding and abetting to the securities laws, and the doctrine may be so well entrenched that the Supreme Court may be reluctant to overturn such settled precedent. In determining the elements of secondary liability for aiding and abetting under the securities laws, the courts have looked to common-law tort and criminal law concepts of aiding and abetting.⁹⁷ Based on these principles, the courts generally require proof of three elements to establish liability. The first requirement is that another party has committed a securities law violation. Second, the accused party must have had a general awareness that his role was part of an overall activity that is improper. Third, the accused party must have assisted the violation knowingly and substantially.⁹⁸ Some courts state the elements somewhat differently, but the distinctions in phraseology do not appear to affect their analysis regard-

⁹⁵ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n.7 (1976). The Supreme Court in *Ernst & Ernst* noted that the Court need not consider whether civil liability for aiding and abetting is appropriate under the section in light of the Court's holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10b-5. *Id.* In a recent case before the Court involving a finding of aiding and abetting liability, the Court observed that it had reserved this issue. However, the Court referred in the same footnote to its holding in *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353 (1982), that participants in a conspiracy who violate a provision of the Commodity Exchange Act analogous to § 10(b) of the 1934 Act can be held liable for damages. See *Herman & MacLean v. Huddleston*, 103 S. Ct. 683, 686 n.5 (1983).

⁹⁶ But see *Brennan v. Midwestern United Life Ins. Co.*, 359 F. Supp. 673, 678 (N.D. Ind. 1966) (statute must be applied flexibly to implement statute's policies and purposes in absence of clear legislative expression to contrary), *aff'd*, 417 F.2d 147 (7th Cir. 1979), *cert. denied*, 397 U.S. 989 (1970).

⁹⁷ Courts have looked for guidance to the Restatement of Torts, § 876(b), which provides that a person is liable for harm resulting to a third person from the tortious conduct of another if he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself." See RESTATEMENT (SECOND) OF TORTS § 876(b) (1977). Reference also has been made to 18 U.S.C. § 2, which imposes criminal liability for aiding and abetting, and to a description of aiding and abetting in the criminal context cited in *Nye & Nissan v. United States*. See 336 U.S. 613, 619 (1949) (quoting *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1933)); see, e.g., *Woodward v. Metro Bank*, 522 F.2d 84, 95 n. 23 (5th Cir. 1975); *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 162-64 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). See also JACOBS, THE IMPACT OF RULE 10(b)-5, § 40.02 nn.1-5 and accompanying text.

⁹⁸ See *supra* note 97. This statement of the elements of liability appears to have originated in *SEC v. Coffey*. See 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). A number of circuits have adopted this language. See e.g., *Cleary v. Perfectune*, 700 F.2d 774, (1st Cir. 1983); *Investors Research Corp. v. SEC*, 628 F.2d 168-78 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); *Decker v. SEC*, 631 F.2d 1380, 1387-88 (10th Cir. 1980); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975).

ing the substance of these requirements.⁹⁹ Notwithstanding the formulation, however, the exact content of the two key elements remains elusive.

Difficulty exists in drawing any clear conclusions from the varying statements that courts have made regarding the degree of awareness and degree of assistance on the part of the defendant required for liability. The Second Circuit recently noted that little has been added to Judge Hand's statement, made in a criminal context, that to be held as an aider and abettor, a person must "in some sort associate himself with the venture, that he participate in it as something that he wishes to bring about, that he seek by his action to make it succeed."¹⁰⁰

While each of the two requirements generally receives separate analysis, courts increasingly have tended to view these requirements as interrelated.¹⁰¹ In the frequently cited case, *Woodward v. Metro Bank*,¹⁰² the Fifth Circuit stressed the need to consider all the circumstances in determining the liability of an alleged aider and abettor, including the ordinariness of the transaction, the nature of the security involved, and any special duties imposed by law on the parties.¹⁰³ The court suggested that the evidence of knowledge and substantial assistance must be weighed together, indicating that a greater degree of knowledge is necessary to satisfy the scienter requirement when the alleged aider and abettor's activity is more remote.¹⁰⁴

A. *Mental State Should Be Essential to Aiding and Abetting Liability*

Of the two requirements, the general awareness or knowledge requirement is the more crucial element. Many courts have noted that important policy considerations make knowledge a critical element of proof.¹⁰⁵ Most

⁹⁹ In a decision preceding the *Coffey* case by a year, the Third Circuit had stated that an independent wrong must exist for aiding and abetting liability. The aider or abettor must know of that wrong's existence and substantial assistance must be given in effecting that wrong. See *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d at 162-63. Some courts have adopted this language without distinguishing it from that in *Coffey*. See, e.g., *Stokes v. Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); see also *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 779-81 (3d Cir. 1976) (applying the *Coffey* formulation). Only the Fifth Circuit appears to have considered the differences in language, adopting the *Coffey* formulation as the more precise. See *Woodward v. Metro Bank*, 522 F.2d at 94-95.

¹⁰⁰ *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980) (citing *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938)).

¹⁰¹ See, e.g., *Stokes v. Lokken*, 644 F.2d at 922 (individual parts of three-part test not considered in isolation, but rather in relation to one another, especially elements of scienter and substantial assistance); *IIT v. Cornfeld*, 619 F.2d at 922 (three requirements cannot be considered in isolation from one another).

¹⁰² 522 F.2d 84 (5th Cir. 1975).

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 95.

¹⁰⁵ See *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir.), cert. denied,

securities transactions require the mechanical assistance of a large number of collateral participants in the usual and customary course of business. Proof of some degree of knowledge of the wrongdoing serves to distinguish participants in the wrongdoing from others innocently engaged in the ordinary course of business. Without this element, banks, brokers, clearing agents, transfer agents and other such participants in the process could become virtual insurers of their customers against securities law violations.

Accordingly, courts have said that the aider and abettor must have knowledge of the illegal conduct of the primary violator, not just of the material facts constituting the illegal conduct.¹⁰⁶ Consistent with this view, courts have held that scienter has not been established in the context of a disclosure violation in which the aider and abettor had a reasonable belief that all facts had been fully disclosed.¹⁰⁷ The application of this principle, however, is complicated by many unresolved questions among the courts regarding the nature and degree of knowledge required for liability and the extent to which the requisite degree of knowledge may vary with other circumstances of the case. This analysis is particularly difficult in the context of aiding and abetting claims premised on inaction or minimal assistance by the defendant. One factor complicating the analysis has been the Supreme Court's decisions in *Ernst & Ernst v. Hochfelder*,¹⁰⁸ and *Aaron v. SEC*,¹⁰⁹ that proof of scienter is a necessary element of a violation of section 10(b) of the 1934 Act. Many courts have concluded that these decisions dictate the result that scienter must be proved as part of a secondary aiding and abetting claim, at least in connection with violations of section 20(b).¹¹⁰ In view of the policy considerations supporting protection of innocent parties engaged in every day business transactions, no court is likely to impose civil liability for aiding and abetting based on ordinary negligence alone.¹¹¹

439 U.S. 930 (1978); *Cumis Ins. Soc. v. E.F. Hutton*, 457 F. Supp. 1380, 1387 n.9 (S.D.N.Y. 1978); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 n.61 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); *Woodward v. Metro Bank*, 522 F.2d 84, 96 (5th Cir. 1975). *See generally* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

¹⁰⁶ *See* *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 779-80 (3d Cir. 1976); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 826-27 (E.D. Wis. 1977).

¹⁰⁷ *See, e.g., Hirsch v. duPont*, 553 F.2d 750 (2d Cir. 1977).

¹⁰⁸ 425 U.S. 185 (1976).

¹⁰⁹ 446 U.S. 680 (1980).

¹¹⁰ *See, e.g., Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981) (aiding and abetting under rule 10b-5); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978) (same), *cert. denied*, 439 U.S. 1039 (1978); *see also* *Stern v. American Bankshares*, 429 F. Supp. 818 (E.D. Wis. 1977) (aiding and abetting under § 12(2) of 1933 Act).

¹¹¹ *See* *Cleary v. Perfectune*, 700 F.2d 774 (1st Cir. 1983) (policy considerations justify requiring proof of scienter as precondition to liability for aiding and abetting violation of §§ 17(a)(2) and 17(a)(3) of the Investment Company Act, notwithstanding that primary violation of those sections does not require proof of scienter).

B. *Scienter is Ill-Defined*

The concept of scienter under the securities laws remains ill-defined.¹¹² Several courts have held that scienter in an aiding and abetting case can be established by proof of recklessness, at least in a case in which the alleged aider and abettor owed a duty to the plaintiff.¹¹³ Of course, the conduct that constitutes recklessness also is subject to tests of varying stringency. Probably, no court would hold that scienter requires proof in every case of actual personal knowledge of all the material facts of the violation.

In construing the knowledge/scienter requirement, some courts have charted new ground, at least in cases arising under provisions of the securities laws other than section 10(b). These courts have focused on the concept of a general awareness of wrongdoing, which describes a mental state involving more than negligence but possibly less than the most stringent test of scienter.¹¹⁴ Further, at least one court has suggested that distinctions in the mental state required for liability may have continued vitality depending on the type of relief sought.¹¹⁵

C. *Conduct of Aider and Abettor Must Be More Than Ministerial*

Judicial construction of the knowing and substantial assistance requirement also has created certain ambiguities. The case law generally indicates that the aider and abettor's conduct must be more than ministerial and must be a substantial factor in the accomplishment of the primary violation when a claim is predicated on affirmative conduct by the alleged aider and abettor. The conduct, however, need not be so important that the undertaking could not have succeeded without it.¹¹⁶ This standard clearly

¹¹² See *infra* text accompanying notes 113-15. In *Ernst & Ernst v. Hochfelder*, the Supreme Court used the term scienter to refer to a mental state embracing intent to deceive, manipulate, or defraud, and found that § 10(b) of the 1934 Act was intended to proscribe knowing or intentional misconduct. 425 U.S. at 193-99. The Court reserved the question of whether in some circumstances reckless behavior is sufficient for civil liability under § 10(b). 425 U.S. at 193-94 n.12.

¹¹³ See *Stokes v. Lokken*, 644 F.2d at 783; *IIT v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980); *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 537 (D. Md. 1978); *Stern v. American Bankshares Corp.*, 429 F. Supp. at 835.

¹¹⁴ See *Investors Research v. SEC*, 628 F.2d 168 (D.C. Cir.) (alleged aiding and abetting under § 17(e)(1) of Investment Company Act), *cert. denied*, 449 U.S. 919 (1980); *Decker v. SEC*, 631 F.2d 1380 (10th Cir. 1980) (same). The *Decker* court noted that the *Investors Research* case as originally filed used the term "scienter" in discussing the state of mind element. However, to avoid confusion stemming from the limited definition given the term "scienter" in *Ernst & Ernst v. Hochfelder* the *Investors Research* court replaced every reference to "scienter" with terms such as "state of mind" or "awareness of wrongdoing." The *Decker* court used similar language in its opinion. 631 F.2d at 1387 n.13.

¹¹⁵ See *Investors Research Corp. v. SEC*, 628 F.2d at 177-78. *But see* *Aaron v. SEC*, 446 U.S. 680 (1980).

¹¹⁶ See *IIT v. Cornfeld*, 619 F.2d at 925 (participation of underwriter defendants not

will be met as the defendant's conduct approaches a primary violation of the securities laws by, for example, participating in the drafting of misleading filings or soliciting approval for the issuance of municipal bonds.¹¹⁷ However, the application of this requirement in which the defendant's conduct is less direct can be more difficult. The courts have provided few helpful guidelines for determining when participation in a business venture constitutes substantial assistance to another party's illegal conduct.

In determining the sufficiency of particular conduct, the Third Circuit has looked to the Restatement of Torts which suggests the relevance of four factors. The first factor is the amount of assistance given by the defendant. Second, the Third Circuit looks to the defendant's presence or absence at the time of the tort. The third factor is the defendant's relation to the other person and, fourth, is the defendant's state of mind.¹¹⁸ The Second Circuit has noted that substantial assistance might include repeating misrepresentations or aiding in their preparation by acting as conduits to accumulate or distribute securities, by executing transactions or investing proceeds, or by financing transactions.¹¹⁹ The court, however, has stressed that such conduct must be a proximate cause of the violation.¹²⁰ For example, the Second Circuit has found the requisite causation when a broker repeatedly reassured an investor of his investment adviser's competence, processed many of the relevant securities orders, and either recklessly failed to learn of, or failed to disclose, the adviser's fraudulent mismanagement of the investor's portfolio.¹²¹

Under certain circumstances, courts have found inaction by a defendant to constitute substantial assistance. Typically, however, when a claim is predicated on the inaction or silence of the alleged aider and abettor, the courts have tried to employ a sliding scale approach and look for proof of a higher degree of scienter. Probably, no court would impose liability on a defendant whose conduct consisted of nothing more than inaction.¹²²

"substantial assistance" in ordinary meaning and underwriting could have proceeded with other in their place).

¹¹⁷ See *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 226-27 (6th Cir. 1982); *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 72-73 (D.C. Cir. 1980).

¹¹⁸ *Landy v. FDIC*, 486 F.2d 139, 163 (3d Cir. 1973) (referring to RESTATEMENT OF TORTS § 436), *cert. denied*, 416 U.S. 960 (1974); see *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

¹¹⁹ *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 48 (citing 2A BROMBERG, SECURITIES LAW § 8.5 (1974)). See *Cumis Ins. Soc'y v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1386 (S.D.N.Y. 1978).

¹²⁰ *Armstrong v. McAlpin*, 699 F.2d 79, 82 (2d Cir. 1983); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980).

¹²¹ *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 48.

¹²² See *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d at 800; *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971) (rule 10b-5 does not impose liability on anyone whose conduct consists solely of inaction).

Some courts, however, have stated that secondary liability may be based on inaction or silence when the alleged aider and abettor consciously intended to forward the violation.¹²³ In what is frequently cited as the leading case on inaction, *Brennan v. Midwestern Life Insurance Co.*,¹²⁴ a dealer in Midwestern stock committed securities law violations of which Midwestern was aware and that had the effect of increasing the value of the stock, thereby benefitting Midwestern in its merger negotiations with another company. The Seventh Circuit affirmed a finding that Midwestern was liable as an aider and abettor, by virtue of Midwestern's acquiescence in the fraudulent conduct in combination with certain minimal affirmative acts. The Second Circuit has interpreted this case to permit liability for inaction when clear evidence exists of the required degree of scienter and a conscious and specific motivation for inaction on the part of an entity with a direct involvement in the transaction.¹²⁵

D. "Special Relationship"

Brennan also has been cited as support for the principle that liability for inaction can be imposed only when a special relationship exists between the parties, since Midwestern had failed to disclose what it knew about the broker's fraud even though customers of the broker had made inquiries to Midwestern.¹²⁶ Several courts have stated that aider and abettor liability also may be predicated on inaction when the defendant had an independent duty to act or to disclose.¹²⁷ This duty to the plaintiff might derive from statutory or common law but does not arise simply by virtue of participation in the proscribed conduct.¹²⁸ The imposition of liability will depend upon the relationship between the defendant's conduct and mental state. The Second Circuit has stated that inaction, when a duty to act exists, can create liability only when a conscious or reckless violation of that duty exists.¹²⁹ Several courts have stated that when a special duty of disclosure exists, liability for inaction should be possible upon proof of

¹²³ *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d at 800; *SEC v. Coffey*, 493 F.2d 1304, 1317 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1976); *see Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. at 536 (liability for inaction may be imposed where conscious intent to aid violation, failure to act due to improper motive, or breach of duty).

¹²⁴ 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

¹²⁵ *IIT v. Cornfeld*, 619 F.2d at 927. The Third Circuit has suggested that when the alleged aider and abettor through has inaction derives benefits from the wrongdoing, the requirement of scienter may be less strict than actual knowledge of the wrong. *See Walck v. American Stock Exch.*, 687 F.2d 778, 791 n.18 (3d Cir. 1982).

¹²⁶ *Landy v. FDIC*, 486 F.2d at 161-62.

¹²⁷ *IIT v. Cornfeld*, 619 F.2d at 925-27; *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975); *Landy v. FDIC*, 486 F.2d at 161; *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973); *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 52 (7th Cir. 1972); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 713 (D. D.C. 1978).

¹²⁸ *Stern v. American Bankshares Corp.*, 429 F. Supp. at 826.

¹²⁹ *IIT v. Cornfeld*, 619 F.2d at 927 (2d Cir. 1980).

a degree of scienter less than that of the high conscious intent type.¹³⁰ When liability is to be based on the combination of inaction or silence and some affirmative acts, the balance may shift slightly.¹³¹

IV. SECONDARY LIABILITY IN SEC ADMINISTRATIVE PROCEEDINGS

Under section 15(b) of the 1934 Act, the SEC has broad authority to discipline both brokerage firms and persons who act on their behalf, following appropriate administrative proceedings.¹³² Of particular relevance, the SEC is authorized to sanction a firm based upon willful violations of the securities laws by the firm's employees. Alternatively, pursuant to provisions added in 1964, the SEC is authorized to sanction a firm based upon the willful aiding and abetting of securities violations by employees or based upon an employee's failure to exercise due care in supervision. Read literally, these grounds for imposing sanctions on a firm appear broader, in many respects, than the bases on which secondary liability has been imposed in civil actions. The statute, however, provides that the SEC shall impose a sanction only if the sanction is in the public interest.¹³³ While the term evades a precise definition,¹³⁴ the requirement that the SEC make a public interest finding may have the effect of conforming the operation of those provisions to generally accepted principles of liability. While little case law exists in this area, and the legal analysis found in SEC administrative decisions tends to be somewhat vague, analysis of the issues presented by these provisions adds an important dimension to the consideration of the problems involved in the imposition of secondary liability.

Section 15(b)(4) authorizes the SEC to sanction a brokerage firm if the SEC finds that the sanction is in the public interest, and that the firm or any person associated with the firm has engaged in certain types of conduct or has been the subject of certain findings specified in subparagraphs (A) through (E) of that provision.¹³⁵ A parallel provision, section 15(b)(6), authorizes the SEC to sanction directly an associated person who has engaged in the specified types of conduct or has been the subject

¹³⁰ *Woodward v. Metro Bank*, 522 F.2d at 97. Some courts have said that a recklessness standard is appropriate in such cases. *Dirks v. SEC*, 681 F.2d 824, 844-45 (D.C. Cir. 1982), *rev'd on other grounds*, 51 U.S.L.W. 5123 (U.S. July 1, 1983); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d at 484-85 (2d Cir. 1979); *Cumis Ins. Soc'y v. E.F. Hutton, Co.*, 457 F. Supp. at 1387 (S.D.N.Y. 1978).

¹³¹ *See Woodward v. Metro Bank*, 522 F.2d at 97 (in case combining silence/inaction with affirmative assistance, degree of knowledge required should depend on how ordinary assisting activity is in the business involved).

¹³² 15 U.S.C. § 78o(b) (1976). The SEC has substantially identical authority to discipline municipal securities dealers, investment advisers, and their "associated persons." *See Securities Exchange Act of 1934* § 15B(c)(2), 15 U.S.C. § 78a-78lll (1976); *Investment Advisers Act of 1940* §§ 23(e), 202(a)(17), 15 U.S.C. § 80b-9(e) (1976).

¹³³ *See* 15 U.S.C. § 78o(b)(4) (1976).

¹³⁴ *See* 2 L. LOSS, *SECURITIES REGULATION* 1323 (2d ed. 1961 & Supp. 1969).

¹³⁵ *See* 15 U.S.C. § 78o(b)(4).

of the specified findings.¹³⁶ For purposes of these provisions, an "associated person" is defined to include not only a partner, officer, director, branch manager, or employee, but also any person controlled by the firm.¹³⁷ Among the specified bases for imposing sanctions, the conduct described in subparagraphs (D) and (E) is more relevant to this discussion.

Subparagraph (D) of section 15(b)(4) permits the SEC to impose sanctions on a firm if the firm or an associated person of the firm willfully has violated any provision of the securities laws.¹³⁸ This provision provides a direct statutory basis for holding a brokerage firm responsible for any securities law violations of its employees, even if not committed within the scope of his employment. Subparagraph (D) also may go beyond the traditional respondeat superior doctrine and include other principles of agency law by making the firm responsible for the acts of any other person controlled by the firm. Under this provision, it would be possible to sanction a firm for an employee's violations even when the firm was blameless, if the sanction served some other public interest. Nevertheless, sanctions generally have not been imposed on a firm in the absence of some degree of fault by the firm.

Prior to the Securities Acts Amendment of 1964,¹³⁹ under the similar provisions of section 15(b),¹⁴⁰ history of administrative decisions exists that, while not explicitly mentioning the doctrine of respondeat superior, makes reference to the principle that the wrongdoing of the employee may be attributed to the firm.¹⁴¹ For example, in *In re Sutro Brothers & Co.*,¹⁴² the SEC stated that a registrant as a firm can act only through its

¹³⁶ *Id.* § 78o(b)(6) (1976).

¹³⁷ *Id.*

¹³⁸ See *supra* note 133. The use of the term "willfully" in this context generally means only intentionally committing the act which constitutes the violation, and does not denote actual knowledge of a violation or scienter. See, e.g., *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

¹³⁹ See Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 6, 78 Stat. 571-72. As relevant herein, the 1964 amendments generally authorized the SEC to discipline individuals as well as firms who violate the securities laws, expanded the range of sanctions to include censure and suspension in addition to revocation of a firm's registration, added violations of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 and the Investment Act of 1940 as grounds for discipline, and added a new provision making the willful aiding or abetting or the failure adequately to supervise grounds for discipline. See S. REP. NO. 379, 88th Cong., 1st Sess. 76 (1963).

Prior to the amendment of § 15 in 1964, § 15(b) provided that the SEC could revoke the registration of a broker or dealer if the SEC found that revocation was in the public interest and that the firm or any partner, branch manager, or controlling or controlled person of the firm, willfully had violated any provision of the 1933 or 1934 Act or rules thereunder.

¹⁴⁰ See *supra* note 139.

¹⁴¹ See, e.g., *In re Sutro Bros. & Co.*, 41 S.E.C. 470, 479 (1963) (Commission also relied on the statutory provisions authorizing discipline of firm based on willful violations of its employees in finding violation); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *In re E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 379 (1945).

¹⁴² 41 S.E.C. 470 (1963).

employees and agents. The court noted that the willful violations of a firm's employees in the course of employment must be considered the willful violations of the firm.¹⁴³ In *In re Sutro Brothers & Co.*, however, the sanction was imposed on other grounds.¹⁴⁴

As an extension of this analysis, a line of authority also has developed that justified the imposition of a sanction on a firm based on the firm's failure to supervise its employees properly. In *In re Bond & Goodwin, Inc.*,¹⁴⁵ the SEC was concerned that a firm would attempt to shield itself from the consequences of an employee's undetected violations by pleading the very conditions which made the violations possible. The court held, therefore, that a firm cannot point to the officer's ignorance of the actual violations to insulate the firm from the consequences of such actions.¹⁴⁶

The SEC relied on the holding in *In re Bond & Goodwin, Inc.* in *In re Reynolds & Co.*,¹⁴⁷ and noted that brokers and dealers are under a duty to supervise the actions of employees.¹⁴⁸ In *In re Reynolds & Co.*, the SEC held that when the failure of a securities firm to maintain and diligently enforce a proper system of supervisions results in the perpetration of fraud upon customers, or in other misconduct in willful violation of the Securities and Exchange Act, such failure constitutes participation. The court stated further that these willful violations may be committed not only by the person who performed the misconduct, but also by those who did not properly perform their duty to prevent the misconduct.¹⁴⁹

Since the adoption of section 15(b)(4)(G) in 1964, section 15(b)(4)(D) has been used to discipline firms for violations of associated persons mainly in cases involving primary violations committed by high-level officers or controlling persons of the firm.¹⁵⁰

The adoption of section 15(b)(4)(E) had the effect of codifying and expanding the SEC's authority to discipline brokerage firms and their associated persons. Subparagraph (E) of section 15(b)(4) authorizes the SEC

¹⁴³ *Id.* at 479.

¹⁴⁴ *See id.* at 481. Notwithstanding the SEC's discussion of other violations attributed to the firm, the basis for the sanction imposed apparently was laxity in office procedures and supervision and a failure to make proper inquiry and investigation regarding the proper registration of certain stock. *Id.*

¹⁴⁵ 15 S.E.C. 584 (1944).

¹⁴⁶ *See id.* at 601.

¹⁴⁷ 39 S.E.C. 902 (1960).

¹⁴⁸ *See id.* at 916. The SEC cited its prior decisions. *Id.*; *see also In re Bond & Goodwin, Inc.*, 15 S.E.C. 584 (1944); *In re E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347 (1945); *In re Kidder, Peabody & Co.*, 18 S.E.C. 559 (1945); *In re R.H. Johnson & Co.*, 36 S.E.C. 467 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956). The SEC also pointed to New York Stock Exchange and NASD rules imposing similar obligations. *See* 39 S.E.C. at 916.

¹⁴⁹ *In re Reynolds & Co.*, 39 S.E.C. at 917. The SEC found that certain individual supervisory personnel had violated or aided and abetted the firm's violation. *Id.*

¹⁵⁰ *See In re Quinn & Co.*, 44 S.E.C. 461 (1971); *In re Jaffee & Co.*, 44 S.E.C. 285 (1970) (sanction of firm set aside for future to give adequate notice of derivative basis of alleged liability), *order aff'd in part, vacated in part*, *Jaffee & Co. v. SEC*, 446 F.2d 387 (2d Cir. 1971).

to sanction a firm if the SEC finds the sanction to be in the public interest, and if the SEC finds that the firm or an associated person willfully has aided or abetted a violation of the securities laws or has failed to supervise reasonably another person who commits such a violation.¹⁵¹ The statute provides a defense to discipline based on a failure to supervise if appropriate supervisory procedures and systems exist, if the supervisor involved has discharged reasonably his duties under those procedures and systems, and if the supervisor has no reasonable cause to believe that the procedures were not being complied with. The SEC also can sanction the associated person directly under section 15(b)(6).

The adoption of this provision had been proposed by the SEC in response to a recommendation by the Special Study of the Securities Markets that broker-dealer supervision over their sales personnel should be strengthened.¹⁵² The Senate report to accompany the Senate version of the bill notes that the SEC consistently had held that partners, branch managers and other supervisory personnel have a responsibility to supervise employees and that sanctions may be imposed on a firm with employees who fail to meet this obligation.¹⁵³ The report explains that the primary purpose of permitting failure to supervise as an additional ground of disciplinary action would be to enable the Commission to reach more directly supervisory personnel who fail to discharge their responsibilities.¹⁵⁴

Although concern was expressed at Congressional hearings leading to the adoption of the 1964 amendments that the addition of this remedy might cause the SEC to stop naming firms in cases involving failure to supervise, the Chairman of the SEC testified that the SEC would proceed solely against individuals only in the relatively unusual case in which no administrative sanction against the firm is warranted.¹⁵⁵ He gave as examples of such a situation, a salesman who, despite proper safeguards and controls, embezzles money or other property from his firm, and a salesman who commits a private securities fraud unrelated to his firm's business.¹⁵⁶

The Senate report asserts the the new subparagraph (E) would not limit the existing power of the Commission to discipline a broker or dealer firm for any violations by a person associated with such broker or dealer.¹⁵⁷ While some evidence exists that Congress was aware of the SEC's reliance

¹⁵¹ See *supra* note 6.

¹⁵² See REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 95, Part 1, 88th Cong., 1st Sess. 328 (1963).

¹⁵³ S. REP. NO. 379, 88th Cong., 1st Sess. 76 (1963).

¹⁵⁴ *Id.*

¹⁵⁵ *Investor Protection, 1963-64: Hearings on H.R. 6789, H.R. 6793, S. 1642 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st and 2d Sess. 1219 (1964) (statement of SEC Chairman William L. Cary).*

¹⁵⁶ *Id.*

¹⁵⁷ S. REP. NO. 379, 88th Cong., 1st Sess. 76 (1963).

on respondeat superior in section 15(b)(4) proceedings,¹⁵⁸ some ambiguity remains as to whether the failure to supervise provisions of subparagraph (E) were intended to supersede the application of respondeat superior in order to render firms liable for their own failure to supervise their employees. Stated another way, the question is whether Congress intended to provide brokerage firms with a reasonable care defense against sanctions based on their failure to supervise.

The policies underlying the doctrine of respondeat superior suggest a substantial argument against this construction of section 15(b)(4)(E).¹⁵⁹ Section 15(b)(4)(E) was intended primarily to permit the SEC to reach individuals, rather than firms, with supervisory responsibilities through section 15(b)(6). The reasonable care defense was provided to prevent these individuals from being held as "absolute guarantors" of their supervisees' conduct.¹⁶⁰ While the limitation makes sense when applied in favor of a supervisory employee, the limitation is far less appropriate when applied in favor of the firm. The supervisory employee's responsibility is only to supervise, and his liability should be limited to his failure to perform this obligation reasonably. In contrast, the firm provides its sales personnel and other supervised employees with their positions and the authority to act for the firm, holds them out as competent and honest advisers, and obtains the main benefits of their services. For these reasons, the common law has held employers responsible for unlawful acts growing out of the employment relationship.¹⁶¹

The one case to address this issue held that section 15(b)(4)(E) does not displace the doctrine of respondeat superior. In *Armstrong, Jones & Co. v. SEC*,¹⁶² the Sixth Circuit noted that the longstanding position of the SEC had been to sanction broker-dealers under respondeat superior.

¹⁵⁸ See *Technical Statement of the Securities and Exchange Commission on H.R. 6789, H.R. 6793, and S. 1642; Investor Protection: Hearings Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 211, 226 (1963)*. The Senate report statement that subparagraph (E) would not limit the existing power of the SEC was adopted verbatim from the "technical statement" in proposed legislation submitted by the SEC to the Congress. *Id.* An earlier version of the SEC's analysis had stated that § 15(b)(4)(E) would not limit the existing power of the Commission to discipline a broker or dealer firm for a violation by an associated person under the doctrine of respondeat superior. See *Technical Statement of the Securities and Exchange Commission Relating to S. 1642, SEC Legislation 1963: Hearings Before a Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess. 352, 363, 364 (1963)*. The deletion of this language suggests an intention, of which Congress presumably was aware, to assure the continued viability of respondeat superior as well as any other available theories of secondary liability. In addition, the SEC's decision in *Sutro Brothers*, was announced less than one week after the SEC had submitted a draft of its proposed § 15(b)(4)(E).

¹⁵⁹ See *supra* notes 140-44 and accompanying text.

¹⁶⁰ S. REP. NO. 379, 88th Cong., 1st Sess. 44 (1963).

¹⁶¹ But see S. REP. NO. 379, 88th Cong., 1st Sess. 44 (1963) (Commission can take disciplinary action only against entire firm which may result in unfair application or no disciplinary action at all).

¹⁶² 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

Although Congress enacted an additional provision giving the Commission the power to impose a sanction on a broker-dealer for failure to supervise its employees adequately, the Sixth Circuit observed that this provision does not limit the Commission's power to discipline a broker-dealer for its employee's acts.¹⁶³

In practice, the distinction between the statutory failure to supervise theory and the doctrine of respondeat superior is not relevant when the firm arguably had met its duty to supervise reasonably.

In *SEC v. Geon Industries*, the Second Circuit affirmed the district court's denial of an injunction against a brokerage firm on a theory of respondeat superior.¹⁶⁴ The court upheld the district court's conclusion that the firm had been innocent of even a negligent failure to supervise. The court also noted that the firm's salesman had made no special use of his connection with the firm and that the firm had obtained no profit from the wrongdoing other than ordinary commissions. Further, the firm had offered rescission to affected investors. Weighing the firm's conduct against what the court saw as the hardship associated with an injunction against the firm, the court held that an injunction in this case would not further the policies of the securities act.¹⁶⁵ The court noted in a footnote, however, that the SEC long has applied respondeat superior in its administrative proceedings even in the absence of any finding of inadequate supervision, but the court declined to pass on the SEC's authority to do so.¹⁶⁶ Nevertheless, the court distinguished SEC proceedings from injunctive actions by noting the wide latitude in the sanctions the SEC can impose, including the option to impose no sanction at all when the circumstances warrant.¹⁶⁷ While the SEC recently has sought to impose a sanction on a firm in administrative proceedings based on a respondeat superior theory in which no finding of inadequate supervision or other culpable conduct was made, this case may raise questions about the propriety of imposing a sanction in such a case.

The language of section 15(b)(4)(E) also leaves unresolved questions about the intended relationship between that provision and other pre-existing theories of secondary liability. For example, some ambiguity exists about whether that provision's aiding and abetting language was intended to incorporate the evolving standards of aiding and abetting liability in

¹⁶³ See *id.* at 359. The Ninth Circuit has cited *Armstrong* with disapproval in rejecting respondeat superior in a private damage action. See *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

¹⁶⁴ See *SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976). The court noted that the firm's salesman had made no special use of his connection with the firm, the firm had obtained no profit from the wrongdoing other than ordinary commissions, and the firm had offered rescission to affected investors. 531 F.2d at 54-55. Of course, such factors relating to the participation or good of the firm are not strictly relevant to traditional respondeat superior analysis.

¹⁶⁵ See *supra* note 164.

¹⁶⁶ 531 F.2d at 55, n.21.

¹⁶⁷ *Id.*

civil securities law actions. As previously indicated, courts recently have required proof of a state-of-mind element greater than negligence before imposing liability for aiding and abetting.¹⁶⁸ The legislative history, however, suggests that Congress intended liability under this statutory provision to be governed by a negligence standard. The Senate report to accompany the 1964 amendments indicate that a person should not be deemed willfully to have aided or abetted under this section if he did not know or have reasonable cause to know, of the acts, omissions, scheme, or plan of the primary securities law violator.¹⁶⁹ Noting that the SEC had held, in a number of cases, that an individual participated in violations by a broker or dealer as an aider or abettor, the report asserts that section 15(b)(4)(E) would codify this practice and clarify the basis for it.¹⁷⁰ The standard which the SEC has applied under section 15(b)(4)(E) is difficult to discern.¹⁷¹

Finally, whether section 15(b)(4)(E)'s failure to supervise provisions would preclude the applicability of the controlling person provisions of the 1933 and 1934 Acts to section 15(b)(4) proceedings is not clear. These provisions could encompass a range of defendants beyond the direct supervisors, but might require proof of greater culpability than does the statutory basis of the reasonable failure to supervise standard. Admittedly, no known judicial or administrative decisions exist that address the applicability of the controlling person provisions to any section 15(b) proceedings, and the SEC may not be inclined to base its determinations on these provisions in view of their good faith defenses. However, to the extent that the requirement of a public interest finding was intended to assure that the interpretation of the provisions of section 15(b)(4) are consistent with accepted notions of liability, an argument exists that, even if findings of violations are made, a sanction should not be imposed if a good faith defense would have been available under the controlling person provisions.

¹⁶⁸ See *supra* note 3 and accompanying text.

¹⁶⁹ S. REP. NO. 379, 88th Cong., 1st Sess. 76 (1963).

¹⁷⁰ *Id.*

¹⁷¹ See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Rel. No. 19070* (Sept. 21, 1982), 26 SEC Docket 254 (report pursuant to § 21(a) of the 1934 Act) (implying that in some circumstances brokerage firm may have duty of inquiry when executing orders in advised accounts, and that continued execution of orders when firm has "knowledge" of improprieties may result in liability for aiding and abetting). The courts are likely to apply the judicially evolved standard. See *Dirks v. SEC*, 681 F.2d 824.

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