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involves not an examination of the facts to find an actual abuse of insider status, but rather an inquiry to determine whether abuses could have taken place,[81] the aggressor cannot mold the transactions to insure that § 16(b) will not apply. In short, the courts' adoption of the subjective approach, while preventing undue hardship in some cases, probably has increased the uncertainty surrounding the application of the section.[82]

VIII. BROKER-DEALER REGULATION

A. The Reasonable Basis Doctrine

(1). Introduction

To further the Securities Exchange Act's goal of providing open and fair securities markets,[1] the SEC and the courts have scrutinized the information given a customer by a broker-dealer when recommending[2] a security by the strict standards of the reasonable basis doctrine. The test provides that a broker-dealer may not

> recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.[3]

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[81] *See* notes 64 *supra*.

[82] It should be pointed out, however, that even if all the courts excluded some transactions from § 16(b)'s scope, the transactions could give rise to Rule 10b-5 claims, which are decided under rules as complex and uncertain as the *Kern* possibility of abuse test. American Standard Inc. v. Crane Co., CCH FED. SEC. L. REP. ¶ 94,924 (2d Cir. Dec. 20, 1974).

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[1] Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1970).

[2] To recommend means to suggest affirmatively, Lipton, *Rule 10b-5: The End of Isolation and New Thresholds of Materiality*, in PRACTICING LAW INSTITUTE, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 311, 326-27 (1974) [hereinafter cited as Lipton], or to present with approval or as favored by the person making the recommendation. Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 MERCER L. REV. 537, 548 (1974) [hereinafter cited as Rice].

[3] Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969), *citing* SEC Securities Exchange Act Release No. 6721 at 3 (Feb. 2, 1962). *See also* Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 882 (1972)

The duty created by the reasonable basis doctrine only applies when a broker-dealer recommends a security. Mere solicitation[4] and less affirmative broker-dealer actions are not governed by the rule.

(2). Broker-Dealer Action Governed by the Reasonable Basis Doctirne.

The 1974 decision *Canizaro v. Kohlmeyer & Co.*[5] illustrates the limits of the reasonable basis doctrine. A brokerage firm, J. B. Williams & Co. offered to sell shares of a small corporation to the plaintiff Canizaro. Attracted by the offer, which expired within twenty-four hours, the plaintiff immediately telephoned an employee of the defendant Kohlmeyer & Co. to inquire whether Kohlmeyer could handle the transaction and could provide answers to some questions concerning the seller and the shares involved in the proposed sale. After determining the answers to the plaintiff's questions, the employee called the plaintiff to report that Kohlmeyer could carry out the transaction and, that based on the information which he had obtained, there was no reason not to make the purchase. The plaintiff then authorized the transaction.[6] When the stock later became worthless, the plaintiff sued Kohlmeyer under Rule 10b-5 for failing to ascertain and disclose all the material facts which allegedly would have shown the speculative nature of the investment.[7]

The *Canizaro* court found for the defendant Kohlmeyer, noting that the plaintiff had defined the scope of the employee's investigation by requesting answers to specific questions and by imposing a twenty-four hour limit on the research. Further, in replying to the plaintiff's questions, the employee gave accurate information, provided no investment opinion, and did not actually recommend the purchase.[8] The court concluded that the duty under the reasonable

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[hereinafter cited as Jacobs]; Rice, *supra* note 2, at 546-47.

[4] Solicitation occurs when a broker-dealer merely contacts a customer to see if he is interested in purchasing a particular security without affirmatively suggesting that the customer buy. Lipton, *supra* note 1, at 326-27. There is, however, a large gray area between a recommendation and a solicitation. *See*, Jacobs, *supra* note 3, at 882.

[5] 370 F. Supp. 282 (E.D. La. 1974), *app. pndg.*, 5th Cir., CCH FED. SEC. L. REP. ¶ 73,031.

[6] *Id.* at 283-85.

[7] The bases of the plaintiff's Rule 10b-5 claim were that the defendant's employee failed to check pink sheet market information before a certain date (failure to investigate leading to failure to state material facts) and also failed to report to the plaintiff that J. B. Williams & Company had ceased dealing with the public possibly due to SEC action (failure to state a known material fact). 370 F. Supp. at 285-86.

[8] *Id.* at 288-89. The court also noted that the plaintiff was an experienced trader in speculative securities. *Id.* at 283.

basis doctrine to research and disclose all material facts should not apply to broker-dealer services which consisted merely of carrying out the customer's instructions and which involved no recommendation by the defendant.

(3). Duty to Educate.

A second recent case reveals the potential importance of full, understanable disclosure when a broker-dealer does recommend a security. The plaintiff in *Cant v. A.G. Becker & Co.*[9] was a longstanding customer of the defendant broker-dealer who usually relied heavily on the defendant's recommendations. Pursuant to established custom, the defendant's employee telephoned the plaintiff on several occasions to recommend the purchase of various speculative securities which the plaintiff in turn bought. Following the requirements of Rule 15cl-4,[10] the defendant sent the plaintiff a confirmation slip after each purchase. Noted on the face of the slip was a coded indication[11] that the defendant broker-dealer was selling the stock from his own inventory and was therefore a principal in the sales transaction. Plaintiff was not otherwise notified of this conflict of interests.[12] When the recommended investments declined in value, the plaintiff filed an action under § 10(b) of the 1934 Act alleging that the defendant's disclosure of material facts was inadequate.

The *Cant* court found that the coded indication of the defendant's principal status was not sufficient to meet Rule 15cl-4's disclosure requirement and held A.G. Becker liable for violating § 10(b).[13] Considersing the plaintiff's heavy reliance on the defendant's recommendations and the long relationship between the parties, the court concluded that the defendant had a duty to "adequately and clearly inform or educate the investor" of its principal status so that the plaintiff could make a "properly informed investment decision."[14] The court was careful to note, however, that the imposition of a duty to educate was limited to cases which involved "a special relationship of confidence."[15]

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[9] CCH FED. SEC. L. REP. ¶ 94,747 (N.D. Ill. 1974).

[10] 17 C.F.R. § 240.15cl-4 (1974).

[11] The code was briefly explained on the reverse side of the confirmation slip. CCH FED. SEC. L. REP. ¶ 94,747, at 96,476.

[12] *Id.* at 96,475-77.

[13] *Id.* at 96,479. Rule 10b-3, 17 C.F.R. § 240.10b-3 (1974), read in conjunction with Rule 15cl-4 makes unlawful the sale of the securities sold in *Cant* without disclosure of the defendant's principal status.

[14] CCH FED. SEC. L. REP. ¶ 94,747, at 96,479.

[15] *Id.*

Although the *Cant* decision did not involve the reasonable basis doctrine, the controlling principles in the case could be extended to require a broker-dealer to educate his customer to the meaning and significance of the facts which he discloses when recommending a security.[16] Such an extension would be consistent with the general policy behind the strict judicial standards for judging recommendations.[17] It is unclear, however, whether courts which might incorporate a duty to educate into the reasonable basis doctrine would confine the duty to cases such as *Cant* which involve longstanding, heavy reliance on the broker-dealer's recommendations. Arguably, a duty to educate all customers is inherent in the standards created by the reasonable basis and suitability doctrines,[18] and in the goals of the 1934 Act. When a broker-dealer discloses material facts in connection with his recommendation of a security, the duty under the suitability doctrine to consider his customer's special needs could be interpreted to require that the broker-dealer phrase his disclosure of material facts in a manner understandable to his customer so that the investor may make an informed decision. However, whether the courts will impose a duty to educate in all or even limited circumstances is very uncertain.[19]

(4). Conflict of Duties and the "Chinese Wall."

More complex issues arise when a broker-dealer's duty to a customer under the reasonable basis doctrine conflicts with a concurrent duty to another client not to disclose inside information.[20] Such a

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[16] The reasonable basis doctrine provides that "a recommendation should not be made without disclosure of material facts, known or reasonably ascertainable bearing upon the justification for the recommendation." BROKER DEALER MODEL COMPLIANCE PROGRAM ADVISORY COMM., SEC GUIDE TO BROKER-DEALER COMPLIANCE 146 (Preliminary Draft 1974) (citations omitted).

[17] *See* CCH FED. SEC. L. REP. ¶ 94,747, at 96,478-79; Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 563-64 (E.D.N.Y. 1971).

[18] Briefly, the suitability doctrine provides that a broker-dealer must "elicit data concerning his customer's investment objectives and financial needs, and, after investigation of the issuer, . . . recommend only those securities he believe[s] to be consistent with those objectives and needs." Jacobs, *supra* note 85, at 897.

[19] *But cf.* Stevens v. Abbot, Proctor & Paine, 288 F. Supp. 836 (E.D. Va. 1968) (churning case in which broker-dealer was held liable where plaintiff, ignorant of securities matters, was not told of the risk that changing an inactive account to an active one might not increase income).

[20] The courts have held that:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do

conflict of duties arose in the 1974 case *Slade v. Shearson, Hammill & Co.*,[21] in which the broker-dealer department of the defendant firm recommended[22] the securities of a corporation which was a client of the firm's investment banking department. The *Slade* plaintiffs alleged that the broker-dealer department promoted the purchase of shares of Tidal Marine Corporation while the investment banking department had adverse, material, inside information showing Tidal Marine to be in financial difficulty.[23] Shearson, Hammill contended, however, that even if one department did have such adverse information,[24] it was precluded from either revealing or acting on the information until the client made the information public.[25] The question presented by the case, therefore, was whether "an investment banker/securities broker who receives adverse material nonpublic information about an investment banking client [is] precluded from soliciting[26] customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading."[27] The district court refused Shearson, Hammill's motion for summary judgment, finding that the defendant had a duty not to recommend securities while in possession

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so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[21] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329 (S.D.N.Y. 1974) (denial of defendant's motion for summary judgment), *remanded for trial*, CCH FED. SEC. L. REP. ¶ 94,914 (2d Cir. Dec. 16, 1974) (declined to hear an interlocutory appeal from district court's denial of summary judgment).

[22] *See* notes 2 & 4 *supra*.

[23] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329, at 95,131.

[24] Shearson, Hammill contended alternatively that the firm did not have the adverse information at the time of the sales to the plaintiffs. The court, examining the evidence in the light most favorable to the plaintiffs, rejected this contention in view of the plaintiffs' assertion that Shearson,Hammill did have some adverse information on the sales dates. *Id.*

[25] The fact situation poses thorny problems because if the defendant withdrew its recommendation on the basis of material inside information, it might breach its duty of confidence to the investment banking client as well as violate the rule set out in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See* Lipton, *supra* note 2, at 336.

[26] "The use of the work 'soliciting' in the certified question is unfortunate . . . . [I]t is clear from the records and the briefs that the word was used in the sense of the securities firm having affirmatively 'suggested' and 'recommended' the purchase [of the Tidal Marine shares]." Lipton, *supra* note 2, at 326-27.

[27] CCH FED. SEC. L. REP. ¶ 94,914, at 97,126 (2d Cir. Dec. 16, 1974) (question certified on interlocutory appeal).

of adverse inside information.[28]

As the district court recognized,[29] solving the conflicting duties problem involves a careful balancing of the various interests of the securities customer, the investment banking client, and the broker-dealer. Under the reasonable basis doctrine, the broker-dealer has a duty to the customer to acquire and disclose all reasonably ascertainable material information.[30] To recommend a security on the basis of information known to be false is a violation of Rule 10b-5 and common law fraud.[31] On the other hand, the investment banker has a duty not to disclose confidential information entrusted to it by a client.[32] The most direct method of removing this conflict would require a division of the investment banking and broker-dealer departments into two separate business entities.[33] However, such an approach overlooks the advantages which accompany the unification of the two functionally distinct departments in one firm.[34] An alternative solution is the creation of a "Chinese Wall"[35] between the broker-

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[28] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329, at 95,132 (S.D.N.Y. Jan. 2, 1974). The court relied on the general rule set out in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[29] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,329, at 95,132.

[30] *See* text accompanying notes 1-4 *supra*.

[31] *See, e.g.*, Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968). In that case, an employee of Shearson, Hammill had access to inside information which contradicted the press releases which were the basis for the defendant's favorable recommendations. The court held the defendant liable for common law fraud, noting:

> [W]e have been given insufficient reason for permitting a person to avoid one fiduciary obligation by accepting another which conflicts with it. . . . The officer-director's conflicting duties is the classic problem encountered by one who serves two masters. It should not be resolved by weighing the conflicting duties; it should be avoided in advance . . . .

72 Cal. Rptr. at 161.

[32] *See* Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[33] *See* Bernstein, *Securities—Class Actions—Beyond Texas Gulf*, N.Y.L.J. Jan. 28, 1974, at 4, col. 5.

[34] *Cf.* Herman & Safanda, *The Commercial Bank Trust Department and the "Wall"*, 14 B.C. IND. & COM. L. REV. 21, 34 (1972) [hereinafter cited as Herman & Safanda].

[35] In this context, a Chinese Wall is a system of internal control which regulates the flow of information between the broker-dealer and investment banking departments of a securities firm. *See* Herman & Safanda, *supra* note 34, at 21. The SEC seems to have approved the theory behind the Chinese Wall. Lipton, *supra* note 2, at 315-18.

dealer and investment banking departments. Although originally designed to prevent the broker-dealer department from making recommendations on the basis of inside information,[36] the Chinese Wall could be used to isolate each department according to its separate function.

Such informational isolation would be consistent with the duties which the firm owes both its customers purchasing securities and its investment banking clients. By not allowing the investment banking department to reveal any non-public information, the firm preserves the client's confidence. Moreover, since material inside information, whether favorable or adverse, would not pass to the broker-dealer department, any recommendations of that department would be based on public information. The broker-dealer department's customers, therefore, would receive both the same data available to all investors[37] and a recommendation based on the same facts underlying the recommendations of other broker-dealers.[38]

Nevertheless, some commentators have urged that even where there is an effective Chinese Wall, a firm's broker-dealer department should not recommend the purchase of securities of any corporation which uses the firm's investment banking services.[39] It is argued that to allow one part of a firm to suggest the purchase of a security on the basis of favorable public information while another department is in possession of adverse inside information would institutionalize action constituting common law fraud.[40] Such an approach would restrict the broker-dealer department to a neutral position on securities of an issuer advised by the investment banking department.

The argument that a securities firm should be limited to solicita-

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[36] *See e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 232 (2d Cir. 1974).

[37] Lipton, *supra* note 2, at 333.

[38] An investor could not successfully sue a broker-dealer for failure to make a recommendation based upon material inside information in violation of Rule 10b-5. *See* Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971) (reprinted at [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163, at 80,522 (SEC July 29, 1971).

[39] Both the SEC and the Solomon Brothers amicus briefs in the *Slade* case urged the adoption of restricted lists which prohibit recommending the shares of a company using the firm's investment department. Slade v. Shearson, Hammill & Co., CCH FED. SEC. L. REP. ¶ 94,914, at 97,129 (2d Cir. Dec. 16, 1974). Another commentator has taken essentially the same approach, arguing that the firm should be required to maintain a neutral stance on the securities of the companies it advises. *See* Lipton, *supra* note 2, at 336.

[40] Lipton, *supra* note 2, at 343.

tion,[41] however, appears to overlook reasons for allowing the broker-dealer department to recommend the investment banking client's securities.[42] Moreover, it would seem inconsistent to advocate the construction of a Chinese Wall and yet assert that a broker-dealer department recommendation conflicting with the investment banking department's confidential information is fraudulent. Since an effective Chinese Wall would prevent the flow of nonpublic information, the normal presumption that one part of a firm has information known to another part should not apply.[43] If the firm actually does control the internal flow of information, the two elements of fraud, a recommendation and information showing the recommendation to be misleading,[44] would not converge because the department making the recommendation would never have information showing the recommendation to be false or misleading. Arguably, therefore, to allow the defense of an effective Chinese Wall[45] in a *Slade* conflict of duties case would best protect the interests of the securities customer, the investment banking client, and the securities firm.

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[41] Solicitation, as opposed to recommendation, does not involve a broker-dealer's affirmatively suggesting the purchase of a security. *See* notes 2 & 4 *supra*.

[42] *See* Slade v. Shearson, Hammill & Co., CCH FED. SEC. L. REP. ¶ 94,914, at 97,129 (2d Cir. Dec. 16, 1974) (citing amicus brief of Paine, Webber, Jackson & Curtis, Inc.); Note, 27 VAND. L. REV. 815, 824-25 (1974).

[43] The rule that notice to an agent (an employee of the investment banking department) is notice to the principal (the securities firm) "rests upon the presumption that the agent will communicate to the corporation the facts learned by him, as it is his duty to it, and whether he performs such duty or not, the corporation is bound." 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 790, at 25. (Perm. ed. rev. repl. 1965) (footnote omitted). The Chinese Wall makes it the duty of investment banking department employees *not* to transmit material information to other departments of the firm. Moreover, an effective wall prevents such transfer. Therefore, the presumed knowledge rule should give way to the reality of information isolation if the broker-dealer can prove that his wall is effective.

[44] *See* Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968).

[45] The courts would carefully examine defenses asserting that inside information did not pass among the various parts of a firm. Investors Management Co., SEC Securities Exchange Act Release No. 9267 n.28 (July 28, 1971).

> [T]he obvious corollary of the Commission's decision is that if it were proven after "close scrutiny" that there had in fact been no "internal communication of material non-public information" within the firm—as by a scrupulously observed "Chinese Wall"—then there would be *no* "tippee" liability: It would have been conclusively demonstrated that the inside information had not been used.

Lipton, *supra* note 84, at 330-31. *See also* Note, 27 VAND. L. REV. 815, 825 (1974).

B. Broker-Dealer Duty to Supervise Employees

Although a plaintiff may rely upon several theories to hold a broker-dealer liable for the acts of its employees, the two most commonly utilized are respondeat superior and the controlling persons provisions of the securities acts.[46] In the past, the courts have divided on the question of whether a plaintiff could establish on the basis of respondeat superior broker-dealer liability for the federal securities acts violations of its employees.[47] The great majority of courts, however, have allowed the plaintiff to proceed under both theories,[48] and the 1974 cases followed this trend.[49]

In applying the controlling persons provision of the 1934 Act, § 20(a), the courts have followed strictly[50] the section's requirements that an employer act in good faith and not directly or indirectly induce the employee's violations.[51] In applying the good faith standard to specific fact situations, the courts have relied on objective measures.[52] Therefore, in *SEC v. Lum's, Inc.*,[53] the court examined

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[46] *See* Note, *The "Controlling Persons" Liability of Broker-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L. J. 824, 825-26 [hereinafter cited as *Controlling Persons Liability*]. The federal securities laws provisions include § 15 of the 1933 Act, 15 U.S.C. § 770 (1970), and § 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1970).

[47] *Compare* Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1209-13 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124 (4th Cir. 1970) (adopted respondeat superior in case involving § 12(2) of the 1933 Act) *with* SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973) (district court refused to apply respondeat superior theory in suit involving § 10(b) of the 1934 Act.). *See Controlling Persons Liability*, *supra* note 46, at 832-38; Comment, *The Controlling Persons Provisions: Conduits of Secondary Liability Under Federal Securities Law*, 19 VILL. L. REV. 621, 626-31 (1974).

[48] Most courts allow the plaintiff to proceed under either theory. *E.g.*, Sennott v. Rodman & Renshaw, 474 F.2d 32, 38-39 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 694-97 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968).

[49] Bird v. Ferry, 497 F.2d 112, 113, 116-19 (5th Cir. 1974); Fey v. Walston & Co., 493 F.2d 1036, 1051-53 (7th Cir. 1974); Isaacs v. Chartered New England Corp., 378 F. Supp. 370, 374 n.1 (S.D.N.Y. 1974).

[50] *See, e.g.*, SEC v. First Sec. Co., 463 F.2d 981, 986-87 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Myzel v. Fields, 386 F.2d 718, 738-39 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[51] "[T]o satisfy the requirement of good faith it is necessary for the defendants to show that some precautionary measures were taken to prevent the injury suffered." Lorenz v. Watson, 258 F. Supp. 724, 732-33 (E.D. Pa. 1966). *See* SEC v. Lum's Inc., 365 F. Supp. 1046, 1064-65 (S.D.N.Y. 1973).

[52] *See Controlling Persons Liability*, *supra* note 46, at 839-44.

[53] 365 F. Supp. 1046 (S.D.N.Y. 1973).

the firm's internal control procedures[54] to decide whether the defendant Lehman Brothers was liable under § 20(a) for the Rule 10b-5 violations of its employee and found the procedures strict enough to meet the good faith standard.[55] The objective test was similarly used in the recent case *Barthe v. Rizzo*,[56] in which the district court held a broker-dealer not liable as a controlling person after proof of the defendant's use of procedures similar to those approved in *Lum's*.[57]

When a court finds that a broker-dealer has not maintained adequate supervision over persons it controls, however, the question arises whether the broker-dealer may rely on defenses other than its own good faith. In the 1974 case *Bird v. Ferry*,[58] a securities salesman for Robinson-Humphrey Company, the defendant broker-dealer, was also an advisor to the plaintiff investment club. When the employee Ferry was hired by Robinson-Humphrey, he brought the club's account with him and put it in his own name. Subsequently, and contrary to the club's instructions, he used the account for his own speculation and lost all of the club's assets.[59] When the club discovered these speculations, it sued Robinson-Humphrey under § 20(a). The district court found for the club.[60]

On appeal to the Fifth Circuit, Robinson-Humphrey contended that because the plaintiff club did not exercise even cursory supervision over its account,[61] it should not be allowed recovery. The Fifth Circuit rejected this contention and affirmed the district court decision, holding that the trial court's finding that the club exercised

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[54] Lehman Brothers maintained a compliance department staffed by attorneys who met with the broker-dealer salesmen to discuss problems of inside information. Moreover, Lehman circulated memoranda, guideline books and a video taped program to keep its employees abreast with Rule 10b-5's requirements. 365 F. Supp. at 1064.

[55] *Id.* at 1065.

[56] 384 F. Supp. 1063 (S.D.N.Y. 1974).

[57] The court's analysis involved two inquiries: first, did the broker-dealer, Kern Securities Co., actually know of the employee's conduct which violated Rule 10b-5; second, were its control procedures sufficient to demonstrate § 20(a) good faith. Finding that Kern had no knowledge of the violating transaction, the court turned to Kern's control procedures, which included a rule requiring the company's president to review private financing deals and distributions of rules and regulations pertaining to the securities laws. The district judge found that although these controls were not as extensive as those employed by Lehman Brothers, *see* note 54 *supra*, they were sufficient to meet Kern's burden of showing good faith under § 20(a). 384 F. Supp. 1068-70.

[58] 497 F.2d 112 (5th Cir. 1974).

[59] *Id.* at 114-16 (Coleman, J., dissenting).

[60] *Id.* at 113, 116.

[61] In its recitation of the facts, the dissent listed several instances of the club's alleged lack of care in supervising its account. *Id.* at 115-16.

sufficient care was not clearly incorrect.[62] The dissent, on the other hand, questioned the finding that the plaintiff had acted diligently in discovering the employee's fraud. However, as support for its contention that the plaintiff's lack of diligence should relieve Robinson-Humphrey of § 20(a) liability,[63] the dissent relied on a Rule 10b-5 suit[64] which had denied a plaintiff recovery since it failed to show due care in detecting the acts giving rise to the suit.[65] Yet because neither the majority nor the dissent in *Bird* rejected the lack of due diligence argument as an improper defense to § 20(a) liability, the decision could be interpreted as allowing a court to balance a broker-dealer's lack of supervision over an employee who violated the 1934 Act against a plaintiff's lack of care in overseeing his account.[66] Such an interpretation, however, is not required either by the provisions of § 20(a) or by the language of the opinion.

Section 20(a) imposes liability when a person controlled by the firm violates the 1934 Act. By definition, therefore, a § 20(a) case must include a determination of whether the controlled person violated one of the Act's provisions. In *Bird*, the employee allegedly violated § 10(b) and Rule 10b-5 by converting the club's account.[67] Robinson-Humphrey's contention that the club was not sufficiently careful, therefore, should be read as a defense addressed to the § 10(b) claim[68] which underlay the § 20(a) allegation, and not to the controlling persons claim alone. Such an interpretation would be consistent with the language of § 20(a) which indicates that the only proper inquiries once an Exchange Act violation is shown are whether the violator was a controlled person and whether the broker-dealer exercised good faith.[69]

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[62] *Id.* at 114.

[63] *Id.* at 117-18.

[64] Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

[65] *See, e.g.*, City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230-31 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[66] Though the majority opinion is not clear, implicit in its holding was a finding that Robinson-Humphrey did not sufficiently supervise its employees during Ferry's employment. 497 F.2d at 114.

[67] *Id.* at 113, 115-16.

[68] *See* cases cited in notes 64-65 *supra*.

[69] *See* note 52 *supra*.