St. John's Law Review

Volume 53
Number 2 *Volume 53, Winter 1979, Number 2*

Article 16

July 2012

Broker Held Liable for Recklessly Aiding and Abetting a Violation of Rule 10b-5 (Rolf v. Blyth Eastman Dillon & Co.)

William T. Miller

SECURITIES LAW

BROKER HELD LIABLE FOR RECKLESSLY AIDING AND ABETTING A VIOLATION OF RULE 10b-5

Rolf v. Blyth Eastman Dillon & Co.

Section 10(b)[1] of the Securities Exchange Act of 1934 and Rule 10b-5[2] promulgated thereunder prohibit fraudulent conduct in connection with the purchase or sale of securities.[3] While it is now clear that these provisions give rise to an implied private cause of action for damages against an individual primarily responsible for the fraud,[4] it is somewhat less settled whether aiders and abettors[5]

---

[1] Section 10(b) provides in part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

[2] Rule 10b-5 provides:

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

17 C.F.R. § 240.10b-5 (1978).

[3] For a general discussion of § 10(b) and Rule 10b-5, see 3 A. BROMBERG, SECURITIES LAW: FRAUD chs. 9, 10 (1977); 6 L. LOSS, SECURITIES REGULATION ch. 9 (2d ed. 1961 & Supp. 1969) [hereinafter cited as Loss].

[4] An implied private cause of action under Rule 10b-5 was first recognized in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). Subsequently, the Supreme Court and a number of courts of appeals also concluded that an action could be pursued under Rule 10b-5. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Christ v. Underwriters, Ltd., 343 F.2d 902 (10th Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir.), *cert. denied*, 365 U.S. 814 (1960); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Beury v. Beury, 222 F.2d 464 (4th Cir. 1955); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). Despite the Supreme Court's increasingly restrictive approach to damage remedies under the securities laws, *see* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 n.15 (1975), its most recent decision on Rule 10b-5 indicates that it will continue to recognize the need for a private cause of action to promote the purposes of § 10(b). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Furthermore, the federal courts have continued to expand the availability of private damages under other provisions of the securities laws.

may be held liable.[6] Even more controversy surrounds the issue of what degree of mental culpability must be established before a defendant may be held liable for damages under section 10(b) and Rule 10b-5.[7] The debate over these issues was intensified by the

---

See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (§ 14(a) of the 1934 Act); Abrahamson v. Fleischner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) (§ 206 of the Investment Advisors Act of 1940); Moses v. Burgin, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971) (Investment Companies Act).

[5] In addition to aiding and abetting, secondary liability under Rule 10b-5 may be imposed for participating in a conspiracy on theories of respondeat superior or "controlling persons." 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).

[6] Aiding and abetting liability under the securities laws had been widely recognized in the federal courts. *See, e.g.*, Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). It is interesting to note that, at the same time the courts were formulating a private cause of action for aiding and abetting under Rule 10b-5, Congress was also moving toward the position of secondary liability for damages. In 1960, the Senate passed several amendments to § 10(b) creating a cause of action for aiding and abetting. S. 3769, 86th Cong., 2d Sess. (1960); *see* 1 LOSS, note 3 *supra*, at 205-06 n.80. The House, however, never acted on these measures. 106 CONG. REC. 17, 125-29 (daily ed. Aug. 3, 1960). Despite rejection of these amendments, the courts refused to find that Congress intended to exempt aiders and abettors from liability. *See, e.g.*, Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 678 (N.D. Ind. 1966); Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963). In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), however, the Supreme Court expressly declined to "consider whether civil liability for aiding and abetting is appropriate under . . . [§ 10(b)] and . . . Rule [10b-5]." *Id.* at 191 n.7. Nevertheless, the lower federal courts and the commentators have had little difficulty in concluding that liability extends to aiders and abettors. *See, e.g.*, Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977); S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS ch. 9.03 (1977); Ruder, *Secondary Liability Under the Securities Acts*, in EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION 353 (1978); Comment, *Rule 10b-5: Liability for Aiding and Abetting After* Ernst & Ernst v. Hochfelder, 28 U. FLA. L. REV. 999 (1976); Note, *The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976); 33 WASH. & LEE L. REV. 937 (1976). The Second Circuit has observed that the elimination of secondary liability would cut away the heart of § 10(b) and protect those who play an indispensable part in the fraud. SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1046 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977).

[7] In the early 10b-5 cases, the federal courts were divided on the question whether scienter is a necessary element in a private damages suit. *Compare* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (2d Cir. 1951) (requiring "the ingredient of fraud"), *and* Howard v. Furst, 140 F. Supp. 507, 512 n.17 (S.D.N.Y.), *aff'd*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957) ("willful misconduct"), *with* Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (negligence) (dicta), *and* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (no scienter required). By 1976, at least three circuits were willing to rest liability on negligence while five circuits required, or suggested that they might require, some form of scienter. *Compare* Carras v. Burns, 516 F.2d 251, 256 (4th Cir. 1975), Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975), Rochez Bros. v. Rhoades, 491 F.2d 402, 407-08 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976), Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974), *and* Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc), *with* Hochfelder v. Ernst & Ernst, 503 F.2d 1100

Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[8] which established a "scienter" requirement for private damage actions, but reserved for future consideration whether scienter encompasses recklessness and whether liability may be imposed for aiding and abetting a violation of the securities laws.[9] Both issues were addressed in *Rolf v. Blyth Eastman Dillon & Co.*,[10] in which the Second Circuit held a broker liable for aiding and abetting a securities fraud although he had no actual knowledge of the illegal scheme and indicated that the reckless breach of fiduciary duty may serve as a substitute for actual knowledge.[11]

The plaintiff in *Rolf* was an investor who had retained Akiyoshi Yamada, a dynamic young investment advisor, to manage his sizeable stock portfolio.[12] Yamada was given full trading discretion with the understanding that he would be supervised by Michael Stott, a registered representative of Blyth Eastman Dillon & Co. (BEDCO),

---

(7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976), White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974), Vanderboom v. Sexton, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), *and* Kohler v. Kohler Co., 319 F.2d 634, 637, 642 (7th Cir. 1963) (dictum). In *Clegg, Smallwood* and *Lanza*, scienter was defined to include recklessness. *See* 507 F.2d at 1061; 489 F.2d at 606; 479 F.2d at 1306.

[8] 425 U.S. 185 (1976).

[9] *Id.* at 191-92 n.7, 193 & n.12. Relying heavily on the language of § 10(b), the *Hochfelder* Court concluded that the words "manipulative or deceptive" and "device or contrivance" indicated a legislative intention to limit liability to intentional or willful conduct. *Id.* at 193. The scope of the scienter requirement enunciated in *Hochfelder* has been the subject of much controversy.

It has been suggested that there are five levels of conduct relating to state of mind:

1. Deliberate conduct exists when the defendant has an intent to injure others.
2. Knowing conduct exists when the defendant acts with the knowledge that his acts may injure others. Knowing conduct would include knowing misrepresentation or nondisclosure.
3. Reckless conduct exists when the defendant acts in conscious disregard of, or indifference to, the risk that others will be misled. This conduct includes what is sometimes referred to as "gross negligence."
4. Negligent conduct exists when the defendant acts unreasonably but does not act with conscious disregard of consequences.
5. Innocent conduct exists when the defendant cannot reasonably be expected to know the true facts.

Ruder, *Factors Determining the Degree of Culpability Necessary for Violation of the Federal Securities Laws in Information Transmission Cases*, 32 WASH. & LEE L. REV. 571, 575 (1975). While the *Hochfelder* decision clearly excludes negligent and innocent conduct as bases for a private cause of action, *see* 425 U.S. at 214, it is unclear whether negligence is sufficient in an SEC enforcement action. *See* 425 U.S. at 194 n.12. *Compare* SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978) (scienter required), *with* SEC v. Aaron, N.Y.L.J., Mar. 14, 1979, at 3, col. 2 (negligence).

[10] 570 F.2d 38 (2d Cir.), *cert. denied*, 47 U.S.L.W. 3391 (U.S. Dec. 5, 1978), *aff'g in part and rev'g in part* 424 F. Supp. 1021 (S.D.N.Y. 1977).

[11] 570 F.2d at 44-48.

[12] *Id.* at 41.

which had maintained Rolf's account for a number of years.[13] Almost from the outset, Stott assumed a "hand-holding" posture, repeatedly assuring Rolf of Yamada's competence.[14] When Rolf began to complain about the continued decline in value of his portfolio, Stott took the position that he was merely an "order taker" and not responsible for the management of the portfolio.[15] During most of the period of Yamada's management Stott was in daily contact with Yamada and was aware of most of the transactions conducted on Rolf's behalf.[16] Although he personally believed the securities selected by Yamada were "junk," Stott never communicated his belief to Rolf.[17] During the period of Yamada's management the value and quality of Rolf's portfolio declined dramatically.[18] Rolf commenced an action against Stott and BEDCO alleging various violations of section 10(b) and Rule 10b-5.[19] The district court found that Yamada had utilized his power over Rolf's account to engage in fraudulent stock manipulations and held that, by breaching his duty to investigate, Stott had aided and abetted Yamada's fraudulent activities.[20]

---

[13] *Id.* In 1963, Rolf had entrusted a discretionary account to one of BEDCO's senior partners. When the partner retired in 1969, Rolf attempted to duplicate his skills by combining Yamada's bold investment techniques with Stott's reliability. *Id.* at 41-42. Rolf's stated goal was to maintain "substantial capital gain in an investment program emphasizing preservation and augmentation of capital." *Id.* at 42.

[14] *Id.* at 43.

[15] *Id.* at 42.

[16] *Id.* In addition to making several "buy" recommendations, Stott executed the trades ordered by Yamada. *Id.* at 42-43.

[17] *Id.* at 43.

[18] *Id.* In May 1969, when Yamada was retained, Rolf's portfolio consisted of high quality stocks and warrants worth $1,423,000. *Id.* at 42. By January 1970, the portfolio had been completely liquidated, 14 of the 20 issues having been sold at a loss. *Id.* These securities were replaced with 41 issues of substantially lower quality, including a restricted security. *Id.* By October 1970, the value of Rolf's portfolio had declined to $446,000. *Id.* at 53.

[19] 424 F. Supp. at 1022.

[20] *Id.* at 1038-39, 1043. The district court also held BEDCO liable under a respondeat superior theory, which has been held to apply to SEC enforcement actions against brokerage firms. *Id.* at 1044 (citing SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975)). In the alternative, the district court found that BEDCO was liable for the actions of Stott, its employee, under § 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1976). Section 20 provides in pertinent part:

> (a) Every person who, directly or indirectly controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or a cause of action.

Id. For a discussion of the relationship between § 20 and the common law respondeat superior

On appeal,[21] the Second Circuit initially concluded that damages are recoverable against a defendant who aids and abets a violation of section 10(b) and Rule 10b-5.[22] Judge Oakes, who authored the majority opinion,[23] then turned to the question whether Stott could be held liable under the scienter standard established in *Ernst & Ernst v. Hochfelder*.[24] Reasoning that the Supreme Court intended to eliminate wholly faultless and good faith conduct as a basis for liability, Judge Oakes concluded that the Second Circuit's traditional view that scienter encompasses recklessness need not be modified.[25] Moreover, the court observed, a more exacting require-

---

doctrine, see Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1017, 1028-34 (1973).

The district court also held that Stott had violated New York Stock Exchange Rule 405, *see* 2 N.Y.S.E. (CCH) ¶ 2405, and article III of the Rules of Fair Practice of the National Association of Securities Dealers (NASD). 424 F. Supp. at 1041. NYSE Rule 405 requires "[e]very member organization . . . to (1) [u]se due diligence to learn the essential facts relative to every . . . account accepted . . . [and to] (2) [s]upervise diligently all accounts handled by registered representatives of the organization." NYSE Rule 405, 2 N.Y.S.E. GUIDE (CCH) ¶ 2405. Similarly, NASD Rule of Fair Practice, art. III, § 2, requires members to make investment recommendations to customers only upon "reasonable grounds for believing that the recommendation is suitable." Noting that the NYSE and NASD rules are designed to protect investors, the district court found them "sufficiently precise to sustain a [private] cause of action" and create duties unknown at common law. 424 F. Supp. 1041. This determination was not reviewed on appeal. 570 F.2d at 48 n.19.

Finally, the district court rejected Rolf's request that damages be measured by net trading losses, holding that damages were to be measured instead according to a "churning" theory, which requires repayment of all commissions and interest thereon. 424 F. Supp. at 1044-45. The court reasoned that any other measure would be too speculative since market factors, unrelated to the defendant's acts, had an effect on the value of Rolf's portfolio. *Id.* For a discussion of the appropriate measure of damages in aiding and abetting cases, see note 29 *infra*.

[21] For purposes of the appeal, BEDCO conceded vicarious liability under 15 U.S.C. § 78t(a) (1976). 570 F.2d at 48. Thus, the only question presented for review was whether Stott, its registered agent, could be held liable.

[22] 570 F.2d at 44 (citing Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977)). The *Hirsch* court assumed without discussion that aiding and abetting is a viable theory of liability under § 10(b) and Rule 10b-5. 553 F.2d at 759.

[23] Judges Smith and Oakes constituted the majority of the *Rolf* panel. Judge Mansfield dissented.

[24] 425 U.S. 185 (1976); *see* 570 F.2d at 44; note 9 *supra*.

[25] 570 F.2d at 46-47 n.15 (citing Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); Shemtob v. Shearson Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971)). In support of his position, Judge Oakes noted that, in reserving the recklessness question, the *Hochfelder* Court cited *Lanza* and numerous other circuit courts of appeals decisions which acknowledged that reckless disregard for the truth is equivalent to scienter. *Id.*; *see* 425 U.S. at 193 n.12. In addition, he pointed to the numerous cases decided since *Hochfelder* upholding liability on the basis of recklessness. 570 F.2d at 46 n.14 (citing Sanders v. John Nuveen & Co., 554 F.2d 790, 792 (7th Cir. 1977); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040, 1043-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993-94 & n.14 (7th Cir. 1976); Stern v. American Bankshares Corp., 429 F. Supp. 818, 825 (E.D. Wis. 1977); McLean v. Alexander, 420 F. Supp. 1057, 1060 (D. Del. 1976)).

ment of specific intent or actual knowledge would impose too great a burden of proof on the injured party and thereby "disembowel" the private cause of action.[26] Noting that the existence of a fiduciary duty presents the most appropriate foundation for the imposition of liability for reckless conduct, the Second Circuit expressly declined to determine whether "recklessness satisfies the scienter requirements where the alleged aider and abettor owes no duty of disclosure and of the loyalty to the defrauded party."[27]

Applying the recklessness standard to the facts, the majority found that Stott's awareness of the inferior quality of the securities, his opportunity to supervise the account, and his constant assurances to Rolf made without having investigated and with utter disregard for whether they had a basis in fact, constituted an extreme departure from the standards of ordinary care and were therefore sufficient to sustain liability for aiding and abetting.[28] Finally, Judge Oakes concluded that Stott had rendered substantial assistance to Yamada's fraudulent activities by processing orders, giving repeated assurances, and failing to learn of or disclose the fraud.[29]

Finally, the *Rolf* court observed that scienter includes "knowing or intentional" conduct and that, at common law, "knowing" encompasses reckless disregard. 570 F.2d at 45.

[26] 570 F.2d at 47.

[27] *Id.* at 44 & n.9.

[28] *Id.* at 47.

[29] *Id.* at 48. Finding that the plaintiff's actual loss was not an overly speculative measure of damages, the *Rolf* court remanded the case to the district court to determine the difference between the value of Rolf's portfolio before and immediately after Stott "began to aid and abet Yamada's fraud." *Id.* at 49. Rolf's gross economic loss was then to be reduced by the "average percentage decline in value" of a well-recognized index of stock market value during the period of Stott's assistance. *Id.* In addition, the court required the defendants to return the commissions paid on the issues traded for Rolf during the aiding and abetting period and requested the district court to reconsider its denial of pre-judgment interest. *Id.* at 50.

15 U.S.C. § 78bb(a) (1976) provides that any recovery under § 10(b) is limited to the amount of "actual damages." While the provision clearly excludes awards for punitive damages, *see* Green v. Wolf Corp., 406 F.2d 291, 302-03 (2d Cir. 1968), *cert. denied,* 395 U.S. 977 (1969), it does little to direct the courts to the appropriate measure of "actual damages." Numerous methods of measuring damages have been suggested. *See* Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages Liability,* 46 FORDHAM L. REV. 277, 281-90 (1977). The most common is the "out-of-pocket" theory. *Id.* at 281; *see* Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962). The recission measure utilized in *Rolf* is common in cases where there is privity or some other special relationship. *See* Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities,* 26 STAN. L. REV. 371 (1974). Damages have also been measured by the amount it would take to " 'cover' by reinvestment and suffer neither loss nor forced sale," Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971), 405 U.S. 918 (1972), by the plaintiff's total economic loss, Chasins v. Smith, Barney & Co., 305 F. Supp. 489 (S.D.N.Y 1969), *aff'd,* 438 F.2d 1167 (2d Cir. 1970), and by the plaintiff's out-of-pocket damages plus the profits made by the defendant, Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965). Most

In a vigorous dissent, Judge Mansfield contended that the facts did not support a finding of liability.[30] He noted that, since Stott had neither actual knowledge nor constructive notice of Yamada's unlawful market manipulation, he could not be found to have aided and abetted Yamada's Rule 10b-5 violations.[31] Moreover, since Yamada's investment in unsuitable securities could not itself constitute a violation of Rule 10b-5,[32] Stott logically could not be held liable for the improper management of Rolf's portfolio.[33] Even assuming that liability could be incurred for making unsuitable investments, Judge Mansfield stated that Stott should not be made civilly accountable for simply assuring a customer of his advisor's competence and executing the advisor's buy and sell orders.[34] Far from establishing "recklessness equivalent to deliberate participation in or aiding and abetting . . . fraud," Stott's omission, in Judge Mansfield's estimation, constituted at worst a negligent breach of fiduciary duty.[35]

Prior to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[36] several courts, including the Second Circuit, approved the use of a recklessness standard in private damages actions arising

---

recently, the courts have been receptive to modifications of these traditional measures by utilizing technical price information, which assures an accurate determination of which losses were sustained as a result of the defendant's actions. Mullaney, *supra*, at 288-90.

[30] 570 F.2d at 50-56 (Mansfield, J., dissenting).

[31] *Id.* at 51-52 (Mansfield, J., dissenting).

[32] *Id.* at 51 (Mansfield, J., dissenting).

[33] *Id.* at 51-56 (Mansfield, J., dissenting).

[34] *Id.* (Mansfield, J., dissenting).

[35] *Id.* (Mansfield, J., dissenting). Judge Mansfield would also have held that NYSE Rule 405 and NASD art. III, § 2 do not give rise to a private cause of action. The courts remain divided on the question whether the rules and regulations of brokers' associations give rise to a private cause of action. The Second Circuit has refused to recognize in a private cause of action based on Article XIV of the New York Stock Exchange Constitution. *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S 817 (1966). Several district and state courts have flatly denied any causes of action under such rules. *E.g.*, Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 890 (D. Conn. 1976); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1st Dist. 1968). *But see* Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678 (D. Wyo. 1975). The Seventh Circuit, however, has held that a violation of NYSE Rule 405 or NASD art. III, § 2 is actionable. Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970); *cf.* Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) (damages available when coupled with sufficient allegations of fraud). While a dispute continues concerning whether the rules were promulgated for the protection of investors, *see, e.g.*, Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970); S. JAFFE, *supra* note 6, ch. 11.10; Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 29 (1966), it is clear that these rules serve to impose and define the duties of a broker-dealer, *see* Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 890 (D. Conn. 1976).

[36] 425 U.S. 185 (1976); *see* note 9 *supra*.

under section 10(b) and Rule 10b-5.[37] Since that ruling was handed down, a number of courts[38] and commentators[39] have reconsidered the issue and again concluded that recklessness satisfies *Hochfelder's* scienter requirement.[40] Thus, it is somewhat surprising that in *Rolf,* the Second Circuit adopted a rather circumspect stance, expressly leaving open the question whether recklessness provides an adequate basis for imposing private damages in the absence of a fiduciary relationship.[41]

One possible explanation for the court's apparent caution lies in the peculiar characteristics inherent in the aiding and abetting theory of liability. Borrowing from common law principles,[42] most

---

[37] *See, e.g.,* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc); Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975); 3 Loss, *supra* note 3, at 1766 (2d ed. 1961); 6 Loss, *supra* note 3, at 3884 (Supp. 1969). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 864 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969).

[38] *See, e.g.,* Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied,* 434 U.S. 940 (1977); Bailey v. Meister Brau, Inc., 535 F.2d 982 (7th Cir. 1976); Steinberg v. Carey, 439 F. Supp. 1233 (S.D.N.Y. 1977); Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977); Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976); McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976). *But see* SEC v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va. 1977).

[39] *E.g.,* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 235-36 (1977); Calhoun, *Divining the Implications of* Ernst & Ernst v. Hochfelder, 1 CORP. L. REV. 99, 112-13 (1978); Note, *Scienter's Scope and Application in Rule 10b-5 Actions: Analysis in Light of* Hochfelder, 52 NOTRE DAME L. REV. 925, 936-37 (1977); Note, *Recklessness Under Section 10(b): Weathering the* Hochfelder *Storm,* 8 RUT.-CAM. L.J. 325, 352 (1977).

[40] One commentator has argued that since recklessness is sufficient in common-law fraud actions, it should also satisfy Rule 10b-5. Note, *Scienter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of* Hochfelder, 52 NOTRE DAME L. REV. 925, 936-37 (1977). Another commentator has stated: "[A]ny decision, even after *Ernst & Ernst,* that holds recklessness insufficient for liability would have to break new ground and develop a theory disregarding the great weight of applicable authority including many cases and commentaries favorably cited by the Supreme Court in *Ernst & Ernst.*" Bucklo, *supra* note 39, at 235-36.

[41] Although, prior to *Hochfelder,* the Second Circuit had clearly disregarded negligence as a basis of Rule 10b-5 liability, *see* Shemtob v. Shearson Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971), the court steadfastly regarded recklessness as a satisfactory degree of scienter. Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc). Additionally, the Second Circuit has concluded that recklessness is a sufficient basis for Rule 10b-5 aiding and abetting liability. *See* Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977).

[42] In the early securities cases, the courts used principles derived from criminal law as a basis for analyzing aiding and abetting liability. *See, e.g.,* SEC v. Time-trust, Inc., 28 F. Supp. 34, 43 (N.D. Cal. 1939), *rev'd on other grounds,* 142 F.2d 744 (9th Cir. 1944) (citing 18 U.S.C.A. § 550). Most modern courts, however, have utilized common-law tort principles. *See, e.g.,* Landy v. FDIC, 486 F.2d 139, 169 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974); H.L. Federman & Co. v. Greenberg, 405 F. Supp. 1332 (S.D.N.Y. 1975); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). *See generally* Ruder, *supra* note 5, at 628.

courts have analyzed aiding and abetting cases in light of three basic elements.[43] The first two elements, the existence of a primary fraud[44] and knowledge or constructive knowledge of the fraud,[45] usually present little analytical difficulty. The third element, however, that the defendant have rendered substantial assistance to the illegality, is somewhat problematic. Under a standard that recognizes reckless disregard for the truth as a substitute for actual knowledge, there is a danger that an individual who has no real awareness of his role in an illegal scheme will be held liable because he unwittingly performed some act or omission which futhered it.[46]

---

[43] In the leading case, Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), the court relied principally on Restatement of Torts § 876 (1939), which states in pertinent part:

> For harm resulting to a third person from the tortious conduct of another, a person is liable if he . . .
>
> . . . .
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

RESTATEMENT OF TORTS § 876 (1939); *accord*, SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc); Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

[44] Most courts have concluded that aiding and abetting liability must be predicated upon an independent violation of the securities laws. *See, e.g.*, Woodward v. Metro Bank, 522 F.2d 84, 97 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974). The Third Circuit, however, has held that any independent wrong can serve as the basis for aiding and abetting liability. Landy v. FDIC, 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

[45] While actual intent or knowledge provide the most reliable foundations for aiding and abetting liability, *see* Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975), such strict theories pose difficult problems of proof. *See* Shemtob v. Shearson Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). Thus, the courts have permitted the use of constructive knowledge theories, basing liability upon a defendant's demonstrated awareness of material facts. *See* Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex. 1971). Even the classic decisions in Derry v. Peek, 14 App. Cas. 337 (1889), and Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931), often cited for their restrictive character, recognized that reckless misrepresentations could constitute fraud. In *Derry*, the court established a strict intent requirement for common-law fraud but stated that liability could be based upon misrepresentations "made (1) knowingly, or (2) without belief in their truth, or (3) *recklessly, careless whether they be true or false.*" 14 App. Cas. at 374 (emphasis added). In *Ultramares*, Judge Cardozo ruled that, although negligence was not sufficient to establish common-law fraud, recklessness or a lack of genuine belief in representations made to another could lead to liability. 255 N.Y. at 186, 174 N.E. at 447-48.

[46] *See* Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975). Even before *Hochfelder* there was some disagreement among the federal courts concerning whether the aiding and abetting defendant must have *knowingly* rendered substantial assistance to the fraud. The Fifth and Sixth Circuits require knowing assistance. Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). While the Third Circuit indicated in an early case that state of mind is irrelevant

In light of the *Hochfelder* Court's rejection of unwitting conduct as a basis for imposing damages under section 10(b),[47] it seems clear that some additional element is necessary to establish that the defendant "knowingly" assisted the primary fraud. In *Rolf*, the defendant's fiduciary relationship to the trader supplied the missing element, since a party with a duty of loyalty and disclosure should be aware that his own reckless conduct will promote an illegality. Similarly, one who makes misleading statements with reckless disregard for their truth or falsity may be deemed to have constructive knowledge of his role in a fraud if he is aware that another will rely on his representations.[48] It is questionable, however, whether without more the *Hochfelder* rule permits an assessment of damages where a defendant's mere failure to investigate has the effect of promoting a fraud.[49]

The *Rolf* court's apparent concern for the defendant's awareness of his role in the illegal scheme is particularly noteworthy since,

---

to the question of substantial assistance, *see* Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1964), in a subsequent decision, the court appeared to be leaning towards the position taken by the Fifth and Sixth Circuits. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 886-87 (3d Cir. 1975).

[47] *See* 425 U.S. at 198, 206. A leading commentator has noted that in many cases an alleged aider and abettor "will merely be engaging in customary business activities, such as loaning money [and] . . . completing brokerage transactions." Ruder, *supra* note 5, at 632. Thus, he concludes, liability must be limited to circumstances evincing other than innocent or negligent conduct. *Id.* at 633. Otherwise, the burden on business would be too severe. *Id.*; *accord*, A. BROMBERG, *supra* note 3, § 8.5, at 582 (plaintiff must prove actual awareness of the party's role in the fraudulent scheme). Indeed, the *Rolf* majority amended its opinion to emphasize, in part, that the decision should not be read to impose liability upon a broker-dealer who simply executes orders. *See* note 49 *infra*.

[48] *See* SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978); Merrill Lynch, Pierce, Fenner & Smith v. Buttrey, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); Trussel v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); *cf.* Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3rd Cir. 1975) (degree of knowledge required varies with the facts of each case). *See generally* A. BROMBERG, *supra* note 3, § 8.5, at 582.

[49] It is interesting to note that two months after the *Rolf* opinion was handed down, the majority added the following footnote:

> This decision does not impose liability on a broker-dealer who merely executes orders for "unsuitable" securities made by an investment advisor vested with the sole discretionary authority to control the account. In the present case, the broker-dealer, although charged with supervisory authority over the advisor and aware that the advisor was purchasing "junk," actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well-founded.

Order supplementing 570 F.2d 38 (May 22, 1978) (adding n.16A).

The seemingly attenuated liability which results when the theories of secondary liability and liability for reckless conduct are combined is alleviated by the implicit requirement that a special relationship exist between the plaintiff and defendant. Thus, continued viability of the aiding and abetting cause of action is assured and compliance with the restrictive spirit of the *Hochfelder* decision is achieved.

prior to *Hochfelder,* the Second Circuit did not appear to require that the defendant knowingly render assistance to the wrongdoer's scheme.[50] The holding in *Rolf,* it is submitted, suggests that the Second Circuit will be more inclined to examine the relationship between scienter and the third element of aiding and abetting liability in future cases arising under section 10(b) and Rule 10b-5.

William T. Miller

---

[50] *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1299-1306 (1973) (en banc). *But cf.* Pettit v. American Stock Exch. 217 F. Supp. 21 (S.D.N.Y. 1963) (knowing assistance). *See also* note 46 *supra.*