Denver Law Review

Volume 70
Issue 4 *Tenth Circuit Surveys*

Article 16

January 2021

Securities Law Survey

Brent J. Gregoire

Securities Law Survey

I. Overview

Caveat brokers, registered representatives, accountants, attorneys and others: investors are not taking their lumps. The investors of today refuse to merely accept the failure or poor performance of their investments. Rather, many sue the deepest pocket and recover handsomely for it.[1] Investors sue broker-dealers for breach of trust and confidence; brokerage houses for respondeat superior or controlling person liability and inadequate supervision; other individuals, including accountants and attorneys, for aiding and abetting; and everyone and anyone for securities fraud. The dramatic increase in the number and magnitude of law suits[2] raises concerns that untempered liability for brokers, registered representatives, accountants and attorneys will have far reaching negative effects on capital markets.[3] Concern over the implications to

1. In 1991, the average claim against accounting firms was for $85 million and the average settlement was for $2.7 million. *Big Six Call for Reforms to Slash Litigation Costs*, 24 Sec. Reg. & Law Rep. (BNA) 36, 1460 (Sept. 4, 1992) [hereinafter *Big Six*]. In 1992, the accounting firm of Coopers & Lybrand agreed to pay $50 million to settle the Texas Miniscribe case. *Company News: A $128.1 million Settlement Reached in Miniscribe Case*, N. Y. TIMES, June 4, 1992, at D5.

2. According to Rep. W. J. Tauzin, (D-LA), 1990 and 1991 witnessed a large jump in the number of securities class action lawsuits filed, with 614 suits filed in all—more than the combined total of the previous five years put together. *Big Six CPA Firms Join Battle Against Deep Pocket Lawsuits; Bills Reduce Liability*, 2 THOMSON'S INT'L BANK ACCOUNTANT, 33, 1 (Sept. 7, 1992). According to a position paper from the Big Six accounting firms (Arthur Andersen, Deloitte & Touche, Coopers & Lybrand, Ernst & Young, KPMG Peat Marwick and Price Waterhouse) the accounting profession as a whole faces about 4,000 lawsuits and $30 billion in claims. *Liability System Threatens Independent Audits; U.S. Capital Markets and Global Competitiveness at Risk; Tort Reform Needed Now*, PR Newswire, N. Y., August 31, 1992, *available in* LEXIS, Nexis library (Fin. News) [hereinafter *Liability System*]. In 1991 the Big Six's total expenditures for settling claims was $477 million, an 18% increase over 1990 which were $404 million. *Id.* A survey by the American Institute of Certified Public Accountants ("AICPA") indicates that claims against firms other than the Big Six rose by two-thirds between 1987 and 1991. *Id.*

3. *See Liability System*, *supra* note 2, at *2. Speculators and their attorneys have utilized the securities laws to coerce nuisance settlements. *Id.* Where a company has had volatile stock price fluctuations, namely mid-sized, high-technology high-growth companies new to the market, speculators file class action securities fraud suits with the sole purpose of coercing settlements. *Id.* To increase the size and prospect of settlement, speculators join accountants and other deep pockets who bear joint and several liability, even where their participation was minimal. *Id.* Under the law the company as the defendant bears the burden for the legal costs of discovery. *Id.* Thus, threats of huge legal fees, tarnished corporate image, and joint and several liability induce companies to settle these nuisance suits despite their innocence. *Id.*

In the aftermath of the failure of the accounting firm of Laventhol & Horwath in 1990, the largest bankruptcy for a professional corporation in U.S. history, accounting firms practice risk reduction. *Big Six*, *supra* note 1. Firms avoid what they perceive as high risk audit clients and industries, including financial institutions, insurance companies, real estate investment firms, high-technology firms and private companies making initial public offerings. *Id.* As a result, three hundred corporate, accounting, financial institution and association members including the Big Six accounting firms, the AICPA, Merrill Lynch & Co., Morgan Stanley & Co., Inc., the National Association of Corporate Directors, the Public Securities Association and the Securities Industry Association have joined together

American business of private securities litigation has prompted members of Congress in both houses to introduce legislation[4] aimed at curbing implied private securities fraud suits under Rule 10b-5.[5]

The U.S. Court of Appeals for the Tenth Circuit has not been immune from these concerns or trends. During the recent survey period the circuit decided three cases involving brokers' and accountants' liability. In all of them, the court refused to attach liability to the brokers or accountants. The court's language in these decisions suggests a judicial attitude reflecting curtailment of, or at least a refusal to expand, the scope of Rule 10b-5 liability. In *Board of County Commissioners of San Juan County v. Liberty Group*,[6] the court reversed the trial court's imposition of liability against a broker for churning based on simple negligence. In *O'Connor v. R.F. Lafferty & Co., Inc.*,[7] the court upheld a grant of summary judgment in favor of the broker, determining that the investor failed to establish the requisite scienter for an unsuitability claim under Rule 10b-5. In curtailing Rule 10b-5 liability, the court imposed an additional requirement of control to establish an unsuitability claim. Finally, in *Farlow v. Peat, Marwick, Mitchell & Co.*,[8] the court dismissed securities fraud claims against an accounting firm for failure to allege fraud with particularity and upheld a summary judgment ruling in favor of the accounting firm on aiding and abetting claims.

---

in the Coalition to Eliminate Abusive Securities Suits ("CEASS") to launch a coordinated federal and state effort to achieve liability reform. *Securities Suits Reform Bill Lauded by Business Coalition*, PR Newswire, N. Y., August 13, 1992, *available in* LEXIS, Nexis Library (Fin. News). According to Philip B. Chenok, president of the AICPA, "The current doctrine of joint and several liability must be replaced if accountants are to continue performing audits in high-risk situations such as initial public offerings." *Id.* Chenok pointed out that a competent outside audit is a requirement for any company seeking to raise capital in the stock or bond markets. *Id.*

4. S. 3181, 102d Cong., 2d Sess. (1992) in the Senate Banking Committee and H.R. 5828, 102d Cong., 2d Sess. (1992) in the House Energy and Commerce Committee were introduced to reduce frivolous securities fraud suits filed to coerce nuisance settlements. To achieve this both bills carry provisions restricting the application of the joint and several liability standard and limiting an actor's liability only to damages that result directly from the actor's work. In addition, both bills provide judicial discretion that can require unsuccessful plaintiffs to shoulder all legal costs. Thus, the bills reduce the coercive tools available to speculators by altering joint and several liability to proportionate liability. The bills also prescribe a disincentive for filing meritless claims. Voting on these bills is scheduled to occur early in 1993.

5. "Rule 10b-5" is the implied right of action for fraud in the purchase or sale of securities found in Rule 10b-5 promulgated under the Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b). 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 statements 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 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 (1992).

6. 965 F.2d 879 (10th Cir. 1992).

7. 965 F.2d 893 (10th Cir. 1992).

8. 956 F.2d 982 (10th Cir. 1992).

II. Recent Tenth Circuit Decisions Show A Reluctance to Expand the Scope of Securities Fraud Liability.

A. *Rule 10b-5 Liability Not Expanded to Include Acts of Mere Negligence*

In *Board of County Commissioners v. Liberty Group* the Tenth Circuit reversed the trial court's expansion of "scienter" to include acts of negligence. In *Liberty Group*, the County of San Juan, New Mexico ("County") used a number of brokers for its investments. Liberty Group executed thirteen transactions in which it charged mark-ups over the price paid for the bonds, but never informed the County of the charges. After the mark-ups were discovered by the State Auditor, the County brought suit under Rule 10b-5 and the Racketeer Influenced and Corrupt Organizations Act ("RICO").[9] The County claimed that Liberty's registered representative had churned the County's account by making frequent trades and charging excessive and undisclosed mark-ups.[10] The jury charge included Instruction 24, which described the requisite mental state for liability on a Rule 10b-5 churning claim as follows:

> The plaintiff, in order to recover on his 10B-5 claim, must show that the defendant acted knowingly, that is, with a mental state embracing intent to deceive, manipulate, or defraud. In order to establish this element the plaintiff must prove by the greater weight of the evidence that the defendant made material statements which he knew to be false, or made statements with reckless disregard for their truth or falsity, *or knew of the existence of material facts which were not disclosed and he should have realized their significance in the making of an investment decision*, or knew of the existence of material facts which were not disclosed although he knew that knowledge of those facts would be necessary to make his other statements not misleading.[11]

The defendants objected that this instruction incorrectly stated the law, asserting that the instruction allowed liability to be imposed for mere negligence.[12] The court denied the objection and the jury found Liberty liable for churning.[13] Liberty appealed.

Although no cases by the U.S. Supreme Court confirm the existence of a churning cause of action, the lower courts generally agree to its existence and elements.[14] Churning, under Rule 10b-5, developed from the New York Stock Exchange (NYSE) Know Your Customer Rule,[15] the National Association of Security Dealers (NASD) Rules of Fair Practice[16]

9. 18 U.S.C. §§ 1961-1964 (1990).
10. *Liberty Group*, 965 F.2d at 881.
11. *Id.* at 883.
12. *Id.*
13. *Id.* at 881-82.
14. *See* Mark C. Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability, and Unauthorized Transactions*, 18 Sec. Reg. L.J. 374, 377-78 (1991).
15. The New York Stock Exchange, *Know Your Customer Rule* provides: "Every member organization is required . . . to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization." NYSE Rule 405, CCH New York Stock Exchange Manual ¶ 2405 (1990).
16. National Association of Securities Dealers, *Rules of Fair Practice*, Art. III, sec. 2(a) ¶ 2152 (1991):

and the Securities and Exchange Rule 15c1-7(a).[17] In the Tenth Circuit, the elements of a churning claim include: (1) excessive trading in light of the plaintiff's investment objectives; (2) control over the trading in the account; and (3) scienter.[18]

The excessive trading element, unique in each churning case, depends upon the investor's objectives and the communication of those objectives to the broker. As a question of fact, excessive trading has been found *prima facie* where the annual turnover rate, the dollar value of the investor's transactions with his broker for the entire year divided by the investor's average monthly equity in his account, is greater than six.[19] However, some have criticized this turnover rate test.[20] The Fifth Circuit, for example, in determining "excessive trading" also considered the nature and objectives of the account, the in-and-out trading, the holding period of the respective securities, the broker's profit, the NYSE Know Your Customer Rule and the NASD suitability rules.[21]

The second element, control, occurs where the broker has actual discretionary authority to execute transactions for the investor without prior authorization. Where the broker lacks discretionary authority, control may occur de facto. For instance, where the investor lacks the ability to evaluate recommendations and to exercise his or her own independent judgment, courts consider the broker to possess de facto control.[22] In determining de facto control, some courts focus on the investor's capacity or practical ability to evaluate the broker's recommendations and to reject unsuitable transactions.[23] Other courts consider that as long as the investor has the capacity to exercise his final

---

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other securities holdings and as to his financial situation and need.

17. Rule 15c1-7(a) prohibits excessively large or excessively frequent trading in discretionary accounts. The Rule provides:

> The term *manipulative deceptive or other fraudulent device or contrivance* as used in section 15(c) of the Act, is hereby defined to include any act of any broker, or dealer or municipal securities dealer designed to effect with or for any customer's account in respect to which such broker, dealer or municipal securities dealer his agent or employee is vested with any discretionary power in any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

C.F.R. § 240.15c1-7(a) (1992).

18. *See, e.g.*, Lafferty, 965 F.2d at 893; Adams v. Merrill Lynch, Pierce, Fenner & Smith, 888 F.2d 696 (10th Cir. 1989); Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384 (10th Cir. 1987).

19. Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980).

20. *See, e.g.*, Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 596-98 (1984) (criticizing the turnover rate as a measure of excessive trading because it ignores other factors).

21. Miley v. Oppenheimer & Co., Inc., 637 F.2d 318 (5th Cir. 1981). *See also Know Your Customer Rule*, NYSE Rule 405, CCH New York Stock Exchange Manual ¶ 2405 (1990); National Association of Securities Dealers, *Rules of Fair Practice*, Art. III, sec. 2, ¶ 2152 (1991).

22. Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676-77 (9th Cir. 1982).

23. *Id.*

right to say "yes" or "no," the investor controls the account.[24]

In *Liberty Group*, the Tenth Circuit did not delve into an analysis of the excessive trading or control elements for churning. Rather, the court determined the case on the issue of the final element, the requisite mental state of scienter,[25] and particularly the defendant's assertion that Rule 10b-5 liability required more than mere negligence.[26] Scienter, common to all Rule 10b-5 claims, exists in a churning claim when a broker acted with actual intent to defraud or with a reckless disregard of the investor's interests.[27]

In *Ernst & Ernst v. Hochfelder*,[28] the United States Supreme Court established that 10b-5 liability required scienter, but expressly declined to decide whether scienter included "recklessness."[29] Six years after *Hochfelder*, the Tenth Circuit joined an emerging trend[30] deciding this question in the affirmative.[31] The court stated that reckless behavior includes "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it."[32] As a result of this and other decisions, Rule 10b-5 liability had expanded to include reckless behavior.

In *Liberty Group*, the Tenth Circuit had opportunity to further expand liability to include acts of mere negligence. Liberty, the defendant, recognized that the language "should have realized" in Instruction 24 provided a finding of fault based on that lesser standard. Liberty argued that scienter should not be expanded because *Hochfelder* required "much more than mere negligence."[33] The Tenth Circuit agreed. It held the trial court's instruction on the Rule 10b-5 count, allowing a finding of fault based on the simple negligence standard of "should have realized," to be error as a matter of law.[34] In doing so the Tenth Circuit restricted an expansion of the scope of Rule 10b-5 liability to acts of simple negligence.

24. Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975) (stating investor has control if she has "sufficient financial acumen to determine her own best interests and she acquiesces in the broker's management").

25. *Liberty Group*, 965 F.2d at 883.

26. *Id.*

27. " 'Scienter is a mental state embracing intent to deceive, manipulate, or defraud.' " *Id.* (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)).

28. 425 U.S 185 (1976).

29. *Id.*

30. *See, e.g.*, G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 961-62 (5th Cir. 1981); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

31. Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982) (expressly holding "recklessness satisfies the scienter requirement").

32. *Id.* at 1118.

33. *Liberty Group*, 965 F.2d at 883 (citing *Hochfelder*, 425 U. S. at 193).

34. *Id.* at 882-83.

B. *Primary and Secondary Liability Restricted Under Rule 10b-5.*

1. Primary Liability Restricted for Breach of Trust and Confidence by Imposing the Element of Control

In *O'Connor v. R. F. Lafferty & Co.*, the Tenth Circuit analyzed a claim of unsuitability and added the requirement of control. In 1975, Carol O'Connor received $200,000 from her divorce and deposited the entire sum into an account with the investment firm of R.F. Lafferty & Company, Inc. ("Lafferty"), to be handled by Roy Foulke.[35] She gave Lafferty and Foulke complete discretion to handle her account. Foulke knew that she relied on him to make all decisions concerning the account, that maintaining a savings account was her only prior investment experience and that her objective was to receive a fixed monthly income. When O'Connor became concerned about the value of her account she directed Foulke to stop all trading. Claiming that Foulke and Lafferty purchased securities unsuitable for her investment objective, she brought suit under Section 10(b) of the 1934 Act and Rule 10b-5 alleging liability against Foulke for unsuitability and against Lafferty as controlling person and under the doctrine of respondeat superior.[36] The trial court granted summary judgment, finding that the defendants lacked the requisite scienter to sustain such a claim.[37] The court also found that although the defendants had invested in unsuitable securities, O'Connor could not demonstrate justifiable reliance on the purchases where she knew that the securities were unsuitable and, acting recklessly, failed to investigate.[38] O'Connor appealed.[39]

In affirming the summary judgment order, the Tenth Circuit, in its analysis of the unsuitability claim, recognized that although the elements for churning were well established, the elements for unsuitability were not. As with churning, unsuitability claims are premised on the NYSE Know Your Customer Rule and the NASD Rules of Fair Practice.[40] Courts analyze unsuitability as either a claim based on material omissions or misrepresentations, or as a claim based on fraudulent practices.[41] Unsuitability claims based on material omission or misrepresentation are widely accepted, amounting to little more than specialized versions of ordinary omission or misrepresentation claims.[42]

35. *Lafferty*, 965 F.2d at 895.
36. *Id.* at 896.
37. *Id.* at 893.
38. *Id.*
39. *Id.*
40. *See supra* note 15-16.
41. *See* San Jose v. Paine, Webber, Jackson & Curtis, Inc., No. C 84-20601 RFP, 1991 U.S. Dist. LEXIS 8318, (N.D. Cal. June 6, 1991).
42. *Id.* at *3. "Under this [omission] theory, it would appear that a suitability claim is merely a specialized form of an ordinary omission claim. *Id.*

For cases accepting unsuitability claims based on omission or misrepresentation, see Lefkowitz v. Smith Barney, Harris Upham, Co., 804 F.2d 154, 155 (1st Cir. 1986); Lazzaro v. Manber, 701 F. Supp. 353, 363 (E.D.N.Y. 1988); Arlington Heights Police Pension Fund v. Poder, 700 F. Supp. 405, 406 (N.D. Ill. 1988); Frota v. Prudential-Bache Sec., Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,253 (S.D.N.Y. 1987); Rush v. Oppenheimer & Co., 592 F. Supp. 1108, 1112 (S.D.N.Y. 1984); M & B Contracting, Corp. v.

An ordinary omission claim occurs when the defendant fails to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.[43] However, for this failure to disclose to be actionable, the defendant must have had a duty to disclose that information.[44] This duty arises out of relationship of trust and confidence between parties.[45] In the typical securities case, the defendant's duty arises from the fiduciary relationship between the broker and the investor.[46] Thus, an omission or misrepresentation based unsuitability claim arises when the defendant, knowing of plaintiff's investment objectives, recommends a course of trading at odds with those objectives. The broker, in effect, is omitting to tell the investor about the unsuitability of the recommendation.[47] The broker may also be breaching a duty to disclose the nature of the recommended transaction in such a way that the investor could understand its ramifications.[48]

In *Lafferty*, however, Ms. O'Connor did not assert that the registered representative failed to tell her the stocks he purchased were unsuitable. Rather, she claimed that he fraudulently purchased stocks for her account. She asserted unsuitability not on omission or misrepresentation, but on fraud by conduct. Unsuitability claims based on fraudulent practices or fraud by conduct are less settled than omission unsuitably claims and courts tend to mix the concepts of traditional securities fraud and fraud by conduct.[49] Due to these differing approaches, a uniform set of elements has yet to be established, though a consensus seems to be emerging. The Second Circuit, in *Clark v. John Lamula & Co.*,[50] first developed elements for unsuitability not based on misrepresentation or omission. The early cases did not describe the claim or define its ele-

---

Dale, 601 F. Supp. 1106 (E.D. Mich. 1984); Mauriber v. Shearson/Am. Express, Inc., 567 F. Supp. 1231, 1237 (S.D.N.Y. 1983).

Procedure in unsuitability cases relates to procedures under traditional securities fraud claims, but the plaintiff's allegations of unsuitability must be sufficiently specific and must be material to an ordinary investor. Craighead v. E.F. Hutton & Co., 899 F.2d 485, 493-94 (6th Cir. 1990); Franks v. Cavanaugh, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,441, 92,845 (S.D.N.Y. 1989). *See also* Osborn v. E.F. Hutton & Co., 853 F.2d 616, 618 (8th Cir. 1988) (upholding claim dismissal where plaintiff failed "to identify any allegedly false representations or a single trade made because of improper advice"); *Lefkowitz*, 804 F.2d at 156 (finding investor's allegations insufficient to establish what objectives were); Bischoff v. G.K. Scott & Co., 687 F. Supp. 746, 750-53 (E.D.N.Y. 1986) (stating alleged investment objectives were insufficiently specific and alleged nondisclosures too vague). *See generally* FED. R. CIV. P. 9(b).

43. 17 C.F.R. § 240.10b-5 (1992).

44. Chiarella v. United States, 445 U.S. 222 (1980).

45. *Id.* at 230.

46. Leason v. Rosart, 811 F.2d 1322 (9th Cir. 1987)(holding brokers have a fiduciary duty to their investors).

47. *Lafferty*, 965 F.2d at 897. *See also San Jose*, 1991 U.S. Dist. LEXIS 8318, at *3.

48. *See, e.g.*, Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 460 (9th Cir. 1986); Kehr v. Smith Barney, Harris Upham & Co., 736 F.2d 1283, 1286 (9th Cir. 1984).

49. Jensen, *supra* note 14, at 386-87.

50. 583 F.2d 594 (2d Cir. 1978).

ments.[51] Under the *Lamula* test the plaintiff merely had to prove that the broker made a recommendation of unsuitable securities with either intent to defraud or reckless disregard for the investor's interests.[52] Unsuitability could be found where the investor proved that the broker knew or reasonably believed the recommended securities were unsuitable but still recommended purchase to the investor.[53]

The modern view, adopted by the Tenth Circuit, regards unsuitability based on fraud by conduct analogous to, or part of, a churning claim.[54] The courts' analysis of this unsuitability claim supports each of the three elements of churning: (1) unsuitability rather than churning—unreasonable quality of transactions rather than excessive quantity of transactions); (2) scienter;[55] and (3) control.[56] The same requirements that establish control in churning claims also define control in unsuitability claims, i.e., control exists through actual discretionary authority on the part of the registered representative, or de facto discretionary authority due to the investor's inability to evaluate recommendations or to exercise independent judgment.[57] Virtually every case that allows fraud by conduct-unsuitability claims to proceed involve allegations of control. However, these unsuitability claims are often combined with or made part of churning claims, which necessarily require control. When both claims are asserted courts do not articulate whether the unsuitability analysis includes a separate element of control. This oversight clouds the description and requirements of the claim for fraud by conduct-unsuitability. In a fraud by conduct claim the defendant has made no overt representation. However, as with any other claim based on si-

51. *See* Hecht v. Harris Upham & Co., 430 F.2d 1202, 1209 (9th Cir. 1970); Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980).

52. *Id.* at 600. As with the misrepresentation-based claim, the fraud by conduct claim also requires the investors' allegations regarding their objectives and resources to be sufficiently specific and material. This specificity with which the investor's objectives and resources are communicated and known by the broker must be alleged and proven. *See, e.g.*, *Craighead*, 889 F.2d at 490-91 (holding complaint must plead specific facts constituting excessive trading); Penson v. Cowen & Co., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,868 (S.D.N.Y. 1990) (dismissing complaint for failing to allege with particularity specific instructions to broker).

53. *Lamula*, 583 F.2d at 600.

54. The First Circuit described an unsuitability claim as going to the quality of the securities compared with churning going to the quantity. Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 4-5 (1st Cir. 1983). *Accord* Lopez v. Dean Witter Reynolds, Inc., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,881 (N.D. Cal. 1984). The Tenth Circuit here held that "[f]raud by conduct is a violation of Rule 10b-5(a) and (c) and is analogous to a churning claim." *R.F. Lafferty*, 965 F.2d at 898.

55. As with other Rule 10b-5 claims, unsuitability requires scienter. Scienter in unsuitability cases has been described as the intent to defraud the investor or the reckless disregard of the investor's interests. *See, e.g.*, Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981).

56. Some courts have explicitly required control in unsuitability claims. Wieringa v. Oppenheimer & Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,986, 90,906 (N.D. Ohio 1985). *See also Craighead*, 899 F.2d at 493-94 (affirming dismissal of unsuitability claim where control was not alleged). While other courts have allowed implied control. Yet, some degree of control is required. *See, e.g.*, *Rolf*, 637 F.2d at 80-81 (no liability for executing orders for unsuitable securities). *Accord* Stander v. Financial Clearing & Serv. Corp., 730 F. Supp. 1282 (S.D.N.Y. 1990).

57. *See supra* notes 22-24 and accompanying text.

lence, liability only occurs under Rule 10b-5 when there is a duty to disclose between broker or agent and client.[58] Showing control establishes a registered representative's duty to his investor because an agent generally has the duty not to misuse the principal's property placed in his control.[59] If control is not required, an alternative duty must be established to ensure the unsuitability doctrine satisfies rule 10b-5.[60]

In *Lafferty* the Tenth Circuit recognized that other circuits required a plaintiff to merely prove unsuitability and scienter to succeed on their claim for unsuitability based on fraud by conduct. The Tenth Circuit imposed the additional element of control. Accordingly a plaintiff must prove three elements to maintain a fraud by conduct unsuitability claim: (1) that the registered representative recommended—or in the case of a discretionary account purchased—securities which are unsuitable in light of the investor's objectives; (2) that the broker recommended or purchased the securities with intent to defraud or with reckless disregard for the investor's interests; and, (3) that the broker exercised control over the investor's account.[61] Here the court determined that although the defendants had invested in unsuitable securities, the plaintiff failed to establish the requisite scienter, since the conduct failed to rise to the level of recklessness necessary to sustain a 10b-5 claim.[62] Accordingly, the court upheld summary judgment dismissing the unsuitability claim, remanding only the state law negligence claims.[63]

The facts in *Lafferty* allowed the court to analyze and decide the case on the issue of scienter alone. Yet, the court went further and imposed the additional requirement of control for fraud by conduct-unsuitability claims, choosing to follow the trend to restrict the scope of Rule 10b-5 liability. This aggressive opinion illustrates the Circuit's reluctance to follow other jurisdictions, which have extended the cause of action for unsuitability. For example, in 1991, unsuitability claims were expanded to include discount brokers who typically take orders, have no discretionary authority, and make no recommendations. An arbitration panel of the National Association of Securities Dealers ("NASD") awarded a Florida investor $39,500 of the $132,000 he claimed to have lost trading options with the brokerage firm of Charles Schwab & Co., Inc.[64] The panel premised its decision on suitability violations. Two of the three arbitrators ruled that Schwab had neglected its "ongoing obligation" to monitor the suitability of its client's investments, strategy and trading decisions.[65] The third arbitrator found Schwab's actions appropriate under the circumstances because the broker appeared to assume an obligation to determine suitability.[66] Under either rationale the award ex-

58. *Chiarella*, 445 U.S. at 235.
59. RESTATEMENT (SECOND) OF AGENCY § 402 (1977).
60. *Chiarella*, 445 U.S. at 222.
61. *Lafferty*, 965 F.2d at 898.
62. *Id.* at 898-900.
63. *Id.* at 900.
64. Peterzell v. Charles Schwab & Co., Inc., NASD, No. 88-02868, June 17, 1991.
65. *Id.*
66. *Id.*

panded unsuitability liability to brokers who neither make recommendations nor have any discretionary authority.[67]

Other courts have expanded broker liability by holding that a violation of the suitability rules support state law claims for fraud.[68] This increases liability by including "negligence" as the requisite mental state sufficient for some state claims.[69] Still other courts have extended liability by providing a private right of action for violations of the NYSE and NASD suitability rules.[70] The majority of modern courts, however, refuse to premise a private right of action upon a violation of an exchange rule.[71] Indeed, the *Lafferty* court refused to decide whether a violation of the NYSE or NASD Rules gave rise to a private cause of action based on negligence, reasoning that actions violating the unsuitability rules give rise to Rule 10b-5 claims.[72] Since Rule 10b-5 violations require proof of scienter,[73] the court refused, as in *Liberty Group*, to extend liability to include acts of mere negligence.[74]

2. Primary Liability Restricted for Failure to Reasonably Supervise

a. *Liability of the Brokerage Firm*

In most cases where a substantial investment amount has been lost, the investor seeks redress not only from the registered representative but also from the brokerage firm and/or supervisors. Investors sue such defendants for inadequate employee supervision of their fraudulent salesman. In *Lafferty*, Ms. O'Connor brought suit against R.F. Lafferty & Company for negligent failure to supervise the conduct of its registered representative, Mr. Foulke.[75]

The New York Stock Exchange and the Self Regulating Organizations (SRO) all require brokerage firms to reasonably supervise their

67. The Schwab decision followed a 1990 arbitration ruling that discount broker Quick & Reilly pay an investor $106,653 for allowing him to trade in naked put options. Quick & Reilly, Inc. and Q & R Clearing Corp. v. Barton, NYSE, No. 9002033, February 15, 1990. Like Schwab, Quick & Reilly had made no specific investment recommendations to its client, nor retained any discretionary authority. *Id.*

68. *See, e.g.*, Mihara v. Dean Witter & Co., Inc., 619 F.2d 814 (9th Cir. 1980); Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 243 (1968).

69. *See, e.g.*, *Lafferty*, 965 F.2d at 900 ("liability under the state analogue to § 12(2) only requires negligence"). *See* COLO. REV. STAT. § 11-51-125(3) (1987). *See also* Pottern v. Bache Halsey Stuart, Inc., 589 P.2d 1378, 1379 (1978) (ruling state analogue to federal Section 12(2) requires only negligence).

70. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 410 F.2d 135, 143 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1040-43 (S.D.N.Y. 1977), *modified on other grounds*, 570 F.2d 38 (2d Cir. 1978).

71. *See, e.g.*, SSH Co. Ltd. v. Shearson Lehman Bros., 678 F. Supp. 1055, 1058 (S.D.N.Y. 1987).

72. *Lafferty*, 965 F.2d at 897 n.5. "Federal courts recognize such a claim [unsuitability] as a violation of § 10(b) and Rule 10b-5." *Id.* at 897.

73. *See supra* notes 25-26 and accompanying text.

74. *Liberty Group*, 965 F.2d at 883. "[T]he appellants . . . [argue] . . . that Ernst & Ernst v. Hochfelder . . . established that 10b-5 liability requires much more than mere negligence. This reading is correct." *Id.*

75. *Lafferty*, 965 F.2d at 903.

registered representatives and establish systems to prevent these agents from violating the securities laws and the rules and regulations of the SROs.[76] A firm may be civilly liable or face regulatory sanctions for fail-

---

76. Section 15(b)(4)(E) of the Securities Exchange Act of 1934 provides sanctions against a broker-dealer found to have:

> failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if - (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

Section 15(f) of the Exchange Act requires broker-dealers to "establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material nonpublic information by such broker or dealer or any person associated with such broker or dealer."

Section 21A of the Exchange Act provides civil penalties against controlling persons who "knowingly or recklessly" fail to establish, maintain or enforce any policy or procedure required under Section 15(f).

NASD Rules of Fair Practice, Article III, section 27 requires members to establish, maintain and enforce written procedures for supervising activities of registered representatives, reviewing customer accounts, and keeping records. Section 27 further requires that members: (1) designate a registered principal for each type of the firm's business to carry out the firm's supervisory obligations; (2) designate an office of supervisory jurisdiction for each location; (3) assign registered persons to a supervisor; (4) make reasonable efforts to ensure that the supervisory personnel are properly qualified; (5) designate a principal to review the firm's supervisory practices and procedures and make recommendations to senior management to assure compliance with the applicable rules and regulations; (6) establish a schedule of branch examinations; and (7) meet at least annually with each registered representative to discuss compliance matters relevant to the representative. The NASD has also recently required members to use their best efforts to obtain the most recent Form U-5 for any person seeking employment in the capacity of a registered representative and to conduct a thorough background search on all prospective account executives.

NYSE Rule 405(2) requires member organizations to "[s]upervise diligently all accounts handled by registered representatives of the organization."

NYSE Rule 342 requires the person in charge of a group of employees to "reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations." The firm must also designate a senior person to have "overall authority and responsibility for internal supervision and control of the organization and compliance with securities laws and regulations." This person must then:

> delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control [and] establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

NYSE Rule 342 also requires member firms to review proprietary trades of the firm and trades of firm employees and family members for insider trading violations and other manipulative and deceptive practices. It also requires that the firm prepare an annual report to its chief executive officers, which discusses, among other matters, customer complaints, internal investigations made during the year, significant compliance problems, and compliance efforts and procedures.

NYSE Rule 351 requires that member firms submit quarterly written reports to the NYSE signed by a senior officer of the firm stating that the firm has reviewed its proprietary accounts and accounts of its employees and family members and that trades in those accounts do not violate the Exchange Act or NYSE rules against insider trading and manipulative and deceptive devices. The firms may use sampling techniques to review proing to reasonably supervise a registered representative who violates a securities law or rule.[77] However, the brokerage firm may avoid liability and sanctions by acting in good faith to fulfill its obligations. Good faith may be established by showing the adequacy of a firm's supervision and compliance systems.[78] There is probably no single supervisory or compliance system appropriate for all brokerage firms. Thus, the rules of the Exchange, the various SROs, as well as the SEC, anticipate each brokerage firm will develop its own system to ensure effective compliance with the various laws, rules and regulations based on the nature of its business. The established supervisory system, however, must meet various SRO requirements.[79] A firm's noncompliance with its own policies may result in liability.[80]

In upholding summary judgment in favor of the registered representative, the *Lafferty* court avoided a complex analysis to determine whether Lafferty inadequately supervised Foulke. The court held instead that no claim for inadequate supervision may be maintained against the brokerage firm without an underlying violation of a securities law or rule by the registered representative.[81] Thus, in restricting the registered representative's liability by imposing a control requirement, the Tenth Circuit has, in effect, restricted the scope of liability faced by the representative's brokerage firm.

b. *Compliance Department Personnel and Other Supervisors' Exposure*

The trend to restrict the scope of untempered exposure for inadequate supervision has been followed by the Securities and Exchange Commission (SEC). Had the registered representative in *Lafferty* violated the securities laws, conceivably his superiors may have faced individual sanctions for failure to adequately supervise. In determining exposure for sanctions the SEC has focused on the lack of adequate procedures,[82] the failure to follow such procedures[83] and the personal fail-

---

prietary accounts and employee accounts, provided that each employee account is reviewed during one of the year's quarters. Rule 351 also requires that members provide the Exchange with statistical information regarding customer complaints relating to matters designated by the Exchange. This provision is yet to be implemented by the Exchange.

77. *See, e.g.*, Securities Exchange Act of 1934, §§ 21A & 15(b)(4)(E).

78. *See, e.g.*, Trustman v. Merrill Lynch, Fenner & Smith, Inc., [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,936 (C.D. Cal. 1985); Smith v. Christie, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,828 (N.D. Cal. 1980).

79. *See, e.g.*, NYSE Rules 342, 351, 405, and 476 and NASD Rules of Fair Practice, art. III, sec. 27, *supra* note 76.

80. Thropp v. Bache Halsey Stuart Shields, Inc., 650 F.2d 817, 820 (6th Cir. 1981) (finding negligence based on defendant's failure to diligently enforce own rules).

81. *See Lafferty*, 965 F.2d at 898-900.

82. *See, e.g.*, Mabon Nugent & Co., Exchange Act Release No. 27301, 1989 SEC LEXIS 1865 (Sept. 27, 1989).

> Effective supervision by broker-dealers is a critical element in the regulatory scheme and its importance has increased as firms have grown in size. As broker-dealers expand their activities through the acquisition of branch offices or into new areas within the securities business, there must be a concomitant expansion of their supervisory procedures to insure regulatory compliance and sound inter-

ure of line and staff supervisors to supervise account executives.[84]

In re Chambers,[85] decided by the SEC in April of 1990, indicated that a chief compliance officer responsible for maintaining adequate supervisory and compliance procedures within a brokerage firm could be held personally liable under section 15(b)(4)(E) of the 1934 Act[86] for deficiencies in supervision.[87] The *Chambers* case was settled and therefore offered little insight about the factual or legal basis for the SEC's position or what steps compliance officers should take to avoid exposure. The concerns raised in *Chambers* subsided following the decision of *In re Arthur James Huff.*[88]

In March of 1991, the SEC commenced an enforcement action against Huff, a vice president in the compliance department of

> nal controls. Apart from adopting effective procedures, broker-dealers must provide effective staffing, efficient resources and a system of follow-up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.

Id. at *2-3.

83. *See, e.g.*, Barlage, Exchange Act Release No. 25563, 1988 SEC LEXIS 740 (April 8, 1988). The SEC found a branch manager liable for failing to supervise a registered representative by not following and enforcing brokerage firm's supervisory policies and procedures, by not enforcing non-solicitation bans, and by not stopping broker's fraudulent solicitations. *Id.* The brokerage firm was also found to have failed to supervise the branch manager. *Id.*

84. *See, e.g.*, Louis R. Trujillo, Exchange Act Release No. 26635, 43 S.E.C. 690 (March 16, 1989). Trujillo, an administrative branch manager of Merrill Lynch, discovered some broker misconduct and reported it to the branch manager, but his supervisory record was "less than exemplary," since a more thorough investigation would have revealed additional misconduct. *Id.* Nevertheless, emphasizing that the statute requires only "reasonable supervision under the attendant circumstances," and the limited scope of Trujillo's authority, the SEC Commissioners held that the SEC staff had failed to prove that "Trujillo's overall performance with respect to the activities of the broker amounted to a failure to supervise." *Id.* The SEC found that Trujillo had made reasonable and diligent efforts to inform the branch manager. *Id.* The SEC also noted the Trujillo had gone over the branch manager's head to place the matter in the hands of higher ranking officials in Merrill Lynch. *Id.* The SEC concluded:

> while we believe that Trujillo could and perhaps should have taken such steps sooner, our standard is that a manager (of any stripe) 'must respond reasonably when confronted with the indication of wrongdoing.' Trujillo's responses as an 'administrative manager' were not unreasonable, and we should not ignore the fact that his actions were a major factor in the broker's dismissal.

Id.

85. Exchange Act Release No. 27963, 1990 SEC LEXIS 808 (April 30, 1990).

86. Section 15(b)(4)(E) of the 1934 Act provides:

> The Commission, by order, shall censure, . . . or revoke the registration of any broker or dealer if it finds, . . . that such censure, . . . is in the public interest and that such broker or dealer, . . . has failed reasonably to supervise, with a view to preventing violations of the [securities laws], another person who commits such a violation, if such other person is subject to his supervision.

Securities Exchange Act of 1934, § 15(b)(4)(E)15 U.S.C. § 78*o*(b)(4)(E).

87. *Chambers*, 1990 SEC LEXIS 808 at *2. Pursuant to an offer of settlement, the SEC entered an order against the Compliance Director of a regional firm finding that he failed to adequately supervise two account executives who had churned investor accounts, engaged in unsuitable transactions, and made oral misrepresentations to investors. *Id.* The SEC found that the Director had been given the responsibility to ensure that the firm adopted and enforced adequate supervisory and compliance procedures. *Id.* The firm's Compliance Manual did not clearly vest responsibility in any supervisor, and thus, the SEC found that the Director had failed to fulfill his responsibilities. *Id.*

88. In re Huff, [1990-91 Transfer Binder] Fed. Sec. Law Rep. (CCH) ¶ 84,719 (March 28, 1991).

PaineWebber Inc., for the alleged failure to supervise a retail salesman and his branch office manager.[89] Huff assisted the entire firm in establishing compliance criteria, while the firm looked to its branch managers to directly supervise its sales staff in all sales activity. Thus, Huff did not directly or indirectly supervise the activities of the retail salesman who committed the underlying fraud. Notwithstanding this, the SEC filed charges alleging Huff had supervisory responsibility for the salesman and his branch manager.[90] An administrative law judge found that Huff had failed to exercise reasonable supervision over both the salesman and the salesman's manager.[91] On appeal, four SEC Commissioners unanimously voted to dismiss the proceeding, but in doing so took two different approaches.

In one opinion, Chairman Breeden and Commissioner Roberts assumed that Huff had the responsibility of supervising the salesman and the branch manager.[92] They then examined whether Huff in fact exercised supervision over the two in accordance with section 15(b)(4)(E). The Commissioners determined that Huff satisfied the reasonableness standard in his compliance efforts over the salesman because he had previously recommended termination of the salesman after analyzing the salesman's customer accounts. The Commissioners dismissed the charge against Huff concerning his alleged deficient supervision of the manager.[93] In deciding this issue, Breeden and Roberts stated that "the 'failure to supervise' by a subordinate is not in and of itself a substantive violation of the securities laws and, therefore, cannot be the predicate upon which a superior can be sanctioned for a second-tier 'failure to supervise.'[94] In their concurring opinion, Commissioners Lochner and Schapiro agreed on the latter issue.[95] Thus, a majority of four SEC commissioners held that an individual with supervisory responsibilities cannot be disciplined for failing to exercise reasonable supervision over another person who did not personally violate the securities laws, but rather was merely sanctioned for failure to supervise his or her subordinate.

While the Breeden-Roberts opinion merely assumed that Huff was responsible for supervising the salesman, the Lochner-Schapiro opinion squarely addressed the issue of staff supervision verses line supervision. Though not adopting a clear staff/line test, the two commissioners noted that in order for section 15(b)(4)(E) to govern a particular situation, a "supervisory relationship" must exist.[96] With the exception of "line supervisors," who have the power to hire, fire, reward or punish, there is difficulty in determining whether one has the supervisory re-

89. *Id.* at 81,395.
90. *Id.* at 81,394.
91. *Id.* at 81,396.
92. *Id.* at 81,397.
93. *Id.* at 81,398.
94. *Id.*
95. *Id.*
96. *Id.* at 81,399.

sponsibility of another. According to Lochner and Schapiro, in the context of staff (non-line) supervision, such a relationship is found only when, inter alia, it should have been clear to the supervisor that he was responsible for the activities of another and that the supervisor had the ability to take effective action to fulfill this responsibility.[97] In effect the two commissioners had announced a definition of the term "supervisor" for purposes of section 15(b)(4)(E). In their view a "supervisor" is a person who "has been given (and knows or reasonably should know he had been given) the authority and the responsibility for exercising such control over one or more specific activities of a supervised person . . . so that such person could take effective action to prevent a violation" of the securities laws or rules.[98]

Thus, in *Huff*, the SEC established that deficient supervision by a subordinate does not in and of itself provide a statutory basis for sanctioning a superior. Absent a clear indication of personal involvement and affirmative wrongdoing on the part of those to whom responsibility is delegated, the SEC will not automatically place liability on senior managers where a violation occurs at a level far removed from them.[99] The SEC's position clearly restricts exposure to liability.

3. Secondary Liability Restricted for "Controlling Person" and Respondeat Superior

Investors not only sue brokerage firms under primary liability for inadequately supervising their registered representatives, but in addition they frequently pursue the firm for secondary liability. A brokerage firm faces secondary liability under a number of different theories. In *Lafferty* the plaintiff alleged that the brokerage firm was secondarily liable both as a controlling person and under the doctrine of respondeat superior for the primary violations of its registered representative, Foulke.

Because secondary liability is so well established, courts rarely question its basis[100] even though federal security statutes do not expressly prescribe such liability with the limited exception of "controlling person" provisions.[101] The U.S. Supreme Court has not yet engaged in a

97. *Id.*

98. *Id.* at 81,401. Under Lochner and Schapiro's analysis, Huff was not the salesman's supervisor because Huff: (1) was not in a position to control the salesman's activities through the traditional methods of reward or punishment and (2) was never clearly given, by his own superiors, authority or responsibility for the salesman's conduct.

At the same time, these Commissioners strongly cautioned that a firm itself may violate the statute if it "fails clearly to assign such supervisory authority and responsibility to specific individuals" as part of its statutory responsibility. *Id.*

99. *Id.* at 81,402.

100. *See* William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws — Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and The Statutory Scheme*, 14 J. CORP. L. 313, 315 (1988).

101. Securities Act of 1933 § 15, 15 U.S.C. § 77*o* (1990); Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78*t* (1990). A few express provisions for secondary liability under an aiding and abetting theory also exist. For example, section 209(e) of the Investment Advisors Act, 15 U.S.C. § 80b-9(e) (1990), and for broker-dealers, section 15(b)(4)(E) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*o*(b)(4)(E) (1990).

detailed analysis of the application of secondary liability concepts to the federal securities laws.[102] However, it has witnessed such an application.[103] In order to find secondary liability the plaintiff must prove that the primary violator performed the central act proscribed by the statute or rule.[104] The secondary violator acquires liability because he assisted or supported the primary violator's act.[105] or through a relationship with the primary violator. Secondary liability from a relationship can be based on either common-law respondeat superior liability or statutory liability for "controlling persons."[106] Although there are some differences between the principal-agent relationship in agency law and the control relationship in the statutory provisions, the imposition of liability under the two concepts of respondeat superior and control person is quite similar.

Under the common law of agency, a principal may be liable for the conduct of his agent. The doctrine of respondeat superior provides: "A master is subject to liability for the torts of his servants committed while acting in the scope of their employment."[107] Under securities laws there are two provisions which hold controlling persons liable to the same extent as the persons they control. Section 15 of the 1933 Act[108] and section 20(a) of the 1934 Act[109] both hold that a person in control of another who violates the securities laws shall be jointly and severally liable with the violator.

Although the two concepts are quite similar, a critical difference exists regarding good faith. The control person provisions expressly provide relief from liability for proof of good faith;[110] agency principles

---

102. Keuhnle, *supra* note 100, at 316-17. The Court expressly reserved decision about aiding and abetting in *Hochfelder*. "[W]e need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule, nor the elements necessary to establish such a cause of action." *Hochfelder*, 425 U.S. at 191-92 n.7

103. *See* Kuehnle, *supra* note 100, at 316-17.

104. *Id.* at 318.

105. *See supra* notes 132-57 and accompanying text for discussion of aider and abettor liability.

106. Kuehnle, *supra* note 100, at 348.

107. RESTATEMENT (SECOND) OF AGENCY § 219(2) (1958).

108. The Securities and Exchange Act of 1933, § 15, 15 U.S.C. § 77*o* (1990) states:

> Every 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 person by or through stock ownership, agency, or otherwise, controls any person liable under sections 77*k* or 77*l* of this title, 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 had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

109. The Securities Exchange Act of 1934, § 20(a), 15 U.S.C. § 78t(a) (1988) states:

> 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 cause of action.

110. *See* Pharo v. Smith, 621 F.2d 656, 673-74 (5th Cir.), *aff'd in part, remanded in part*, 625 F.2d 1226 (5th Cir. 1980); Carpenter v. Harris Upham & Co., Inc., 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

under the doctrine of respondeat superior do not relieve the principal from liability even when he acts in good faith.[111] The principal's liability is, however, limited to the acts done within the scope of the agent's employment.[112] The conflict between the two doctrines concerning good faith has divided the courts over whether the two federal securities provisions are exclusive of common law agency principles.[113] The majority of circuits hold that Congress did not intend to supplant agency law with the controlling person provisions, but enacted the provisions to provide an additional basis of secondary liability.[114] In fact, the majority of courts hold that respondeat superior has concurrent liability with controlling person liability.[115] Nevertheless, under both provisions, liability is derivative. Absent an underlying violation by the controlled person (registered representative), no claim against the controlling person (brokerage firm) may be maintained.[116]

Thus, in order for the plaintiff in *Lafferty* to succeed in an action against the brokerage firm she must have shown: (1) a primary securities violation by the registered representative; and (2) control of that representative by the brokerage firm.[117]

Conversely, substantial disagreement exists between courts regarding the correct operation of "control" in control person liability. The dividing issue is whether the federal provisions apply only to individuals who actively control the primary violator (culpable participation), or whether the provisions also apply to individuals who have a general, rather than a direct, relationship of control over the violator. Courts that mandate culpable participation require the controlling person to have control over the primary violator and to directly exercise that con-

111. *See, e.g.*, New York Cent. R.R. v. White, 243 U.S. 188, 198 (1917) (holding employer who exercised utmost care still liable for acts of employees while acting in scope of employment).

112. *See* Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980. *See also* Harrison v. Dean Witter Reynolds, Inc., 715 F. Supp. 1425 (N.D. Ill. 1989) (refusing to impose liability on basis of respondeat superior where broker sold municipal bonds in manner contrary to firm's rules and where transactions were "anything but regular"); Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347 (S.D.N.Y.), *aff'd*, 719 F.2d 5 (2d Cir. 1983) (finding investment banker not liable for acts of employee/tippee because trading on inside information not within the scope of employment); RESTATEMENT (SECOND) OF AGENCY §§ 228-29 (1958) (defining acts within the scope of employment).

113. *See* Kuehnle, *supra* note 90, at 349-54. "The circuits are divided, with the clear majority holding for agency liability and against exclusivity." *Id.* at 349.

114. *Id.* at 350.

115. Gerald F. Rath & David C. Boch, *Selected Issues in Broker/Customer Litigation*, 751 A.L.I.- A.B.A. Course of Study 557 (1992)[hereinafter *Issues*]. This carefully documented work examines each circuit for their rulings on this issue and generally finds none that have expressly denied concurrent liability, with the possible exception of the Third. *Id.*

For the Securities and Exchange Commission's view see the amicus brief in Hollinger v. Titan Capital Appeal No. 87-3887 (9th Cir. file Nov. 9, 1989). *See also Recent SEC Amicus Brief Supports Respondeat Superior Liability in Private Action*, 4 INSIGHTS 1 (Jan. 1990) (respondeat superior liability should be imposed concurrently with the statutory liability of section 20(a) to protect the public).

116. Deviries v. Prudential-Bache Securities, Inc., 805 F.2d 326 (8th Cir. 1986); Roberts v. Heim, 670 F. Supp. 1466 (N.D. Cal. 1987); Baum v. Philips, Appel & Walden, 648 F. Supp. 1518 (S.D.N.Y. 1986).

117. Gruber v. Prudential-Bache Securities, Inc., 679 F. Supp. 165 (D. Conn. 1988).

trol with the intent to bring about a violation. Courts not mandating culpable participation do not require participation by the controlling person in the violation,[118] but some relation between control and the violation is required. The circuit courts' positions suggest that some are inclined to support secondary liability based merely on relationship, while others impose liability based on action.[119]

In those jurisdictions requiring active or culpable participation, the investor-plaintiff must show the controlling person's real control over the violator. This may be shown from the relationship in general—as in showing that the primary violator was an employee of the defendant corporation. The plaintiff must then show that the scope of control included the conduct that was the basis of the primary violation—as in showing that the employee's particular violative conduct was within the scope of the corporation's control. The plaintiff need not show, however, that the control was exercised to cause the violation.

This approach appears to comport with the intent of the statute.[120] It requires the plaintiff to prove the ability to exercise control without having to make the more difficult proof of the actual exercise of the control in this particular violation—a matter within the knowledge of the defendant and relevant to the good faith defense. Thus, in courts following this approach the plaintiff must establish culpable participation before the defendant addresses the good faith defense.[121] In those courts not following the culpable participation approach, however, when the plaintiff establishes the defendant had control over the primary violator the "control" element is satisfied and the burden immediately shifts to the defendant to establish the good faith defense.[122]

The Tenth Circuit appears to have rejected culpable participation. It has imposed liability on brokerage firms for their representative's underlying violation without reference to culpable participation.[123] Therefore, in *Lafferty*, had Ms. O'Connor been able to establish an underlying violation by Foulke, the burden would shift to Lafferty to estab-

118. *See, e.g.*, G.A. Thompson & Co v. Partridge, 636 F.2d 945, 958 (5th Cir. 1981) ("Neither this [regulatory] definition nor the statute appears to require participation in the wrongful transaction.")

119. *See* Kuehnle, *supra* note 100, at 354-55 n.211. Kuehnle found the following different circuit treatments: three circuits appear to require culpable participation (Ninth, Second and Third); five have rejected culpable participation either expressly or impliedly through their analysis of the control elements in a way that is inconsistent with culpable participation (Tenth, Eighth, Seventh, Sixth and Fifth); and the issue is unclear or has not been decided in the remaining circuits (Fourth, First and D.C.). *Id.*

120. *See supra* notes 104-06 and accompanying text.

121. Orloff v. Allman, 819 F.2d 904, 906-07 (9th Cir. 1987); Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978); Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 779 (3d Cir. 1976); Gordon v. Burr, 506 F.2d 1080, 1086 (2d Cir. 1974);

122. *See* San Francisco-Oklahoma Petroleum Exploration Corp. v. Carstan Oil Co., 765 F.2d 962, 964 (10th Cir. 1985); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980); Hecht v. Harris Upham & Co., 283 F. Supp. 417, 438 (N.D. Cal. 1986).

123. *See, e.g.*, Busch v. Carpenter, 827 F.2d 653, 659-60 (10th Cir. 1987); *San Francisco-Oklahoma Petroleum Exploration Corp.*, 765 F.2d at 964-66; Richardson v. MacArthur, 451 F.2d 35, 41 (10th Cir. 1971).

lish the good faith defense, because of its control of Foulke.[124]

Both statutory provisions make available to the brokerage firm the good faith defense.[125] To prove good faith:

> it is necessary for the controlling person to show that some precautionary measures were taken to prevent an injury caused by an employee. . . . It is required of the controlling person only that he maintain an adequate system of internal control and that he maintain the system in a diligent manner.[126]

The precise standard of supervision required of the brokerage firm to establish the good faith defense is uncertain.[127] However, where the registered representative completes the violative transaction through the employing brokerage and the firm receives a commission on the transaction, the burden of proving good faith is on the brokerage.[128] The brokerage must show that no negligence has occurred in supervision of the registered representative,[129] and that it has maintained and enforced a reasonably reliable system of supervision and internal control over such personnel.[130]Thus, Lafferty could have defended against the secondary liability claim by proving it had maintained and reasonably enforced a proper system of supervision over Foulke—in other words, by establishing the good faith defense.

The doctrine of respondeat superior does not, however, provide such a defense. Under this doctrine the primary focus concerns the scope of employment and whether an employee's acts can fairly be considered within the scope of employment.[131] Here, the only defense available to Lafferty is where Foulke acts beyond the scope of his employment. Obviously, whenever a court restricts the scope of primary liability, it in effect restricts any derivative secondary liability. Again, as a result of the Tenth Circuit's restricting the scope of primary liability for the registered representative in *Lafferty*, the scope of secondary liability for the brokerage firm was also restricted.

---

124. As a matter of law, a brokerage firm is a controlling person with respect to its registered representatives. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990).

125. *See* Carpenter v. Harris Upham & Co., Inc., 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Pharo v. Smith, 621 F.2d 656, 673-74 (5th Cir.), *aff'd in part, remanded in part*, 625 F.2d 1226 (5th Cir. 1980) (analogous statutory provisions interpreted similarly).

126. *Carpenter*, 594 F.2d at 394. *Accord* Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (stating that to prove good faith broker-dealer must show "supervisory system was adequate and that it reasonably discharged its responsibilities under the system"); Trustman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,936 (C.D. Cal. 1985) (holding that defendant was not in compliance with duty of good faith). *See generally*, 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, 1037 (1973) (and cases cited therein).

127. *See Marbury*, 629 F.2d at 716.

128. Stern v. American Bankshares Corp., 429 F. Supp. 818, 823 (E.D. Wis. 1977).

129. SEC v. Geon Industries, Inc., 531 F.2d 39, 54 (2d Cir. 1976); *Gordon*, 506 F.2d at 1085-86.

130. Zweig v. Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir. 1975).

131. *Marbury*, 629 F.2d at 716.

4. Secondary Liability Restricted for Aiding and Abetting

The case of *Farlow v. Peat, Marwick, Mitchell & Co.*[132] offers further evidence of a Tenth Circuit trend to restrict liability in Rule 10b-5 cases. During the period 1979 until 1986, Patrick Powers and his related entities (collectively Powers) offered and sold over fifty limited partnerships. The limited partners who invested in the offerings claimed that Powers defrauded investors in 58 limited partnerships by making numerous misrepresentations while the partnerships were nothing more than "worthless shells" without value.[133] The plaintiffs further claimed that Peat, Marwick, Mitchell & Company (Peat Marwick), the accounting firm that audited Powers, became "involved in the fraud" in April, 1981, when it agreed to certify the Powers' financial statements, which it knew to be "materially false and inaccurate."[134] The disgruntled limited partners brought suit against the accounting firm for, inter alia, aiding and abetting.[135] The Tenth Circuit upheld the lower court's dismissal of the plaintiffs' claims for failure to allege fraud with particularity under Rule 9(b).[136] The court noted that the allegations failed to specify which plaintiffs had dealt directly with Peat Marwick, from which persons the plaintiffs had purchased their interests, and on which occasions the misrepresentations were made and how they were directed to plaintiffs.[137]

Employers and others, including agents such as accountants and attorneys, can be held liable under an aiding and abetting charge. Although the federal securities laws generally do not provide for such liability[138] and the U.S. Supreme Court has reserved ruling on the issue,[139] courts almost universally infer liability for aiding and abetting by utilizing the joint tortfeasor language in the *Restatement (Second) of Torts*.[140] In order to establish aider and abettor liability under Rule 10b-5, the facts must show a violation by the primary violator, knowledge of that violation by an aider and abettor, and "substantial assistance" by the aider and abettor.[141]

---

132. 956 F.2d 982 (10th Cir. 1992).

133. *Farlow*, 956 F.2d at 985.

134. *Id.*

135. *Id.* at 986.

136. Rule 9(b) of the Federal Rules of Civil Procedure provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." FED. R. CIV. P. 9(b).

137. *Farlow*, 956 F.2d at 987-89.

138. There are a few provisions of the federal securities laws that expressly provide for aiding and abetting liability. *See, e.g.*, Investment Advisors Act § 209 (e), 15 U.S.C. § 80b-9(e) (1990). Broker-dealers are subject to administrative sanctions for willfully aiding and abetting violations of the federal securities laws. *Id. See also* Securities Exchange Act of 1934 § 15(b)(4)(E), 15 U.S.C. § 78o(b)(4)(E) (1990)(allowing the Commission to censure, place limitations on activities, suspend or revoke the license of broker dealers who willfully aid or abet violation).

139. *See Hochfelder*, 425 U.S. at 191 n.7.

140. *See* Kuehnle, *supra* note 100, at 321-22.

141. Employers Insurance of Wausau v. Paine, Webber, Jackson & Curtis, Inc., [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,792 (S.D.N.Y. 1982). *See* Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983) (aiding and abetting churning allegation against stockbroker sufficient to withstand motion to dismiss); Board of Trustees v. Liberty Group, 708 F. Supp. 1504 (N.D. Ill. 1989). *See generally*, Woods v. Barnett Bank of Fort Lauder-

The second and third elements of aiding and abetting liability present the greatest difficulty. The first element, a violation by a primary violator usually has been decided by the time aiding and abetting liability is being considered. The two difficult elements demand a determination of the level of assistance and knowledge required in order to apply liability for aiding and abetting. In determining the level of assistance required courts turn again to the Restatement, which imposes liability when one person breaches a duty and another gives "substantial assistance or encouragement to the other so to conduct himself."[142] While the defendant may be aware a violation is occurring, unless he acts to aid the violation or fails to act when he had a duty, no liability attaches.[143] The Restatement measures assistance essentially under the principles of causation.[144] An "[a]ctor's negligent conduct [will be] the legal cause of harm to another if . . . his conduct is a substantial factor in the bringing about [of] the harm . . . ."[145] Thus, in determining whether substantial assistance has been given by the aider and abettor, one must find a substantial causal connection between the assistance and the violation. That causal connection can arise from either the aider's action or inaction, as long as the action or inaction caused the harm.[146] In determining the causal connection, and thus the degree of assistance, consideration is given to the number and effect of other variables, and to whether the conduct was harmless until acted upon by other forces or was part of a continuous stream of forces leading to the resulting harm.[147]

---

dale, 765 F.2d 1004 (11th Cir. 1985); Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983); Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38 (2d Cir. 1978); Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975); Hemming v. Alfin Fragrances, Inc., 690 F. Supp. 239 (S.D.N.Y. 1988).

142. RESTATEMENT (SECOND) OF TORTS § 876(b) (1977).

143. Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 800 (3d Cir. 1978) (holding "mere knowledge of a violation alone, without assistance or a duty to disclose the violation, is not an actionable wrong").

144. The cmt. for clause b of § 876 states: "In determining liability, the factors are the same as those used in determining the existence of legal causation when there has been negligence . . . or recklessness . . . ." RESTATEMENT (SECOND) OF TORTS § 876(b), cmt. d (1977). *See also* Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1084 (N.D. Cal. 1979) (finding there must be substantial causal connection between conduct of alleged aider and abettor and harm to plaintiff).

145. RESTATEMENT (SECOND) OF TORTS § 430, cmt. d (1977).

> It is not necessary that it be *the* cause, using the word 'the' as meaning the sole or even the predominant cause. The wrongful conduct of a number of third persons may also be a cause of the harm, so that such third persons may be liable for it, concurrently with the actor.

Id. (emphasis in original).

146. *See* Kuehnle, *supra* note 100, at 342.

> [L]iability for nonaction requires a showing of the breach of a duty or a showing of conscious intent. A breach of duty can constitute causal assistance. If one owed a duty to the plaintiff and the failure to fulfill the duty permitted the harm to occur, the person owing the duty could be said to have assisted the violation. The duty, the breach of which could be said to be a cause of the harm, could arise from a statutory obligation under the securities laws or from another, indirect basis of duty including custom, practice, contract, or special relationship.

Id. (footnotes omitted).

147. *See, e.g.*, Wessel v. Buhler, 437 F.2d 279, 282-83 (9th Cir. 1971); RESTATEMENT (SECOND) OF TORTS § 533 (1977). Kuehnle states:

In determining the level of knowledge required for an aider and abettor, the Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co.*,[148] considered whether the Rule 10b-5 standard of knowledge matched the scienter needed for primary 10b-5 liability. The court concluded that "the basic holding of *Hochfelder*, that scienter is an element of the section 10(b)/Rule 10b-5 cause of action, also establishes the standard for aiding and abetting liability."[149] Considering whether recklessness constitutes scienter for an aiding and abetting violation, the Second Circuit concluded that "at least where, as here, the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement."[150]

Although the issue of recklessness for Rule 10b-5 liability is not fully resolved, it has almost universal acceptance as constituting scienter for primary 10b-5 violations. However, recklessness is not as well accepted for secondary aider and abettor liability. Some courts allow recklessness to satisfy the scienter requirement for aider and abettor liability without any special circumstances.[151] Other courts recognize recklessness as an appropriate standard only under special circumstances. For example, courts requiring special circumstances have allowed recklessness to satisfy the scienter requirement in aider and abettor liability where a fiduciary relationship exists between the victim and the aider and abettor,[152] where the aider and abettor could reasonably foresee that the plaintiff would rely upon his actions[153] and where the aider and

> Activity that is otherwise harmless does not constitute assistance where the activity has been made harmful by the intervention of other, corrupting forces. Thus, where an accountant prepares interim financial statements for a company and informs the company of deficiencies in the company's books, the accountant is not liable for the subsequent alteration of those statements and their use in a prospectus by another.

Kuehnle, *supra* note 100, at 340 n.154. *But see* SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973)(giving opinion letter on securities issue makes securities lawyer participant in stream of events leading to securities transaction; letter may be legal causal factor constituting substantial assistance even if flow of events takes several turns).

148. 570 F.2d 38, 44 (2d Cir. 1977).

149. *Id.*

150. *Id.*

151. *See* Herm v. Stafford, 663 F.2d 669, 684 (6th Cir. 1981) (holding circuit law is either scienter or recklessness is sufficient to fulfill requirement); Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979) (prevailing rule is willful or reckless behavior satisfies scienter requirement).

152. *See* Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004, 1010 (11th Cir. 1985) (holding severe recklessness satisfies scienter requirement in aiding and abetting case, at least where alleged aider and abettor owes duty to defrauded party); Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983) (owing fiduciary duty to plaintiff makes recklessness sufficient for liability for aider and abettor); IIT v. Cornfeld, 619 F.2d 909, 923 (2d Cir. 1980) (noting that fiduciary duty is recognized as special consideration allowing recklessness as satisfaction of scienter requirement for aider and abettor liability); *Rolf*, 570 F.2d at 48 (alleged aider and abettor owing fiduciary duty allows recklessness to satisfy scienter requirement); Hudson v. Capital Mgmt. Int'l, Inc., 565 F. Supp. 615, 624 (N.D. Cal. 1983) (ruling that recklessness only suffices fiduciary or analogous relationship binds defendant to plaintiff).

153. *See Woods*, 765 F.2d at 1011 (following precedent applying "recklessness standard to alleged aiders and abettors who have issued statements or certifications foreseeably relied upon by investors"); Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314, 1356-57 (S.D.N.Y. 1982) (stating although courts generally don't regard accountant-

abetter receives a benefit from the fraud.[154]

Still other courts developed and utilized a sliding scale approach linking the level of knowledge required to the degree of assistance rendered.[155] This approach scales the level of knowledge upward or downward depending upon the amount and type of assistance rendered. A stronger showing of knowledge is required where the assistance is remote or routine.[156] In 1979 the Tenth Circuit followed the less restrictive approach toward aiding and abetting liability and stated "[t]he prevailing rule would appear to be that . . . reckless behavior satisfies the scienter requirement" for aiding and abetting.[157]

However, in *Farlow*, the Tenth Circuit, following the trend of restricting the scope of liability, also stated that it is not the law that whistle-blowing to protect investors is necessitated whenever an accountant discovers his client to be in financial trouble.[158] The failure to disclose material information is actionable only where a duty to disclose arises,— when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.[159] The duty to disclose does not arise from the relationship between the parties merely because one party has an ability to acquire information.

The court in *Farlow*, like the *Lafferty* court, affirmatively addressed an issue that did not direct its decision. The facts in *Farlow* permitted the court to dismiss the case for failing to specifically plead fraud pursuant to Rule 9(b).[160] Yet, the court stepped forward and restricted the scope of Rule 10b-5 liability by refusing to adopt the whistleblower or

client relationship as fiduciary, recklessness standard applies where accountant's misleading audit or opinion letter leads to foreseeable reliance); Morgan v. Prudential Group, Inc., 527 F. Supp. 957, 961 (S.D.N.Y. 1981) (holding that reliance on attorney's tax opinion is foreseeable, and where foreseeability of reliance is apparent recklessness standard may be applied); Investors Funding Corp. of N.Y. Sec. Litig., 523 F. Supp. 550, 558 (S.D.N.Y. 1980) (ruling recklessness sufficient to establish scienter where plaintiff/third party reliance on accountant's audit or opinion letter is reasonably foreseeable).

154. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 780 (3d Cir. 1976) (knowledge requirement less strict where alleged aider and abettor derives benefits from wrongdoing).

155. *See, e.g.*, Abell v. Potomac Ins. Co., 858 F.2d 1104, 1126-27 (5th Cir. 1988)(explaining previously adopted test that establishes scienter by relating level of assistance to level of intent); Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985) (holding knowledge and assistance factors vary inversely relative to one another; where evidence of substantial assistance is slim requirement of knowledge or scienter is enhanced); *Cornfeld*, 619 F.2d at 923.

156. *See, e.g.*, Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975) ("scienter requirement scales upward when activity is more remote").

157. Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979).

158. *Farlow*, 956 F.2d at 988.

> "That [whistleblower liability] would be an extreme theory of accountants' liability, and it is one we decline to embrace as an interpretation of the common law of Illinois, having in previous cases specifically rejected it as a possible theory of Rule 10b-5 aider and abettor liability."

Id. at 988 (citing Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986) and LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 932-33 (7th Cir. 1988).

159. Chiarella v. United States, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

160. *Farlow*, 956 F.2d at 984-89.

financial Good Samaritan theory of liability for accountant liability, thereby refusing to expand the duty to disclose.[161]

III. CONCLUSION

Although the Tenth Circuit is not a hot bed for securities litigation, it nonetheless is subject to the trend to restrict the scope of Rule 10b-5 liability. Without articulating its position, the Tenth Circuit has illustrated through three decisions last year its reluctance to expand securities fraud liability. Indeed, the court addressed questions restricting Rule 10b-5 liability when such questions were never posed. The Tenth Circuit now requires specific allegations of the who, what, where, when and how in pleading a 10b-5 violation in order to defeat an opposing motion for summary judgment or dismissal. The court also requires the element of control for unsuitability claims based on fraud by conduct and no whistleblower or financial good Samaritan theory of liability exists in the Tenth Circuit. One may argue that these imposed requirements illustrate the Tenth Circuit's willingness to take affirmative steps to reduce securities fraud litigation by restricting liability. Evident from their voiced concerns, the business sector shares an attitude that securities fraud litigation has grown beyond an acceptable limit and affirmative steps need to be taken to reduce liability. This attitude is already apparent in the courts, as witnessed from their application of securities fraud issues. What remains uncertain is whether Congress agrees with this attitude. The answer to that question shall remain a matter of speculation until Congress hears the Senate and House bills in 1993.

Brent J. Gregoire

161. *Cf.* The Financial Fraud Detection and Disclosure Act H.R. 4313, 102d Cong., 1st Sess. (1992) (Whistleblower Act) introduced by Rep. Ron Wyden, (D-OR), approved by the full House Energy and Commerce Committee July 28, 1992 and opposed by AICPA. American Banker-Bond Buyer, a Div. of Thomson's Int'l Bank Accountant, 2 U.S. BANK ACCOUNTING LEDGER 38, at 6 (October 12, 1992) *available in* LEXIS, Nexis Library The bill would authorize the SEC to direct independent auditors to investigate their clients for fraud and other wrongdoing. *Id.* The proposal would require auditors to report management fraud to company officials, and also set forth procedures for auditors to follow if they discover potential illegalities during the course of an audit engagement. *Id.*