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# Recent Cases

SECURITIES REGULATION - Fraud - Reckless Conduct Satisfies Scienter Requirement when Fiduciary Duty is Owed to Investor. *Rolf v. Blyth, Eastman, Dillon & Co.,* 570 F.2d 38 (2d Cir. 1978).

In *Rolf v. Blyth, Eastman, Dillon & Co.*[1] the Court of Appeals for the Second Circuit[2] announced that if a broker owes a fiduciary duty to an investor, reckless conduct by the broker is the legal equivalent of scienter. The decision eliminates, at least in the Second Circuit, one of the important questions left undecided by the landmark case *Ernst & Ernst v. Hochfelder*,[3] that is, whether reckless behavior meets the requirement of scienter[4] in a civil action under rule 10b-5.[5] The court held a registered representative and his brokerage firm liable for aiding and abetting a fraud perpetrated on an investor by an investment advisor and awarded the investor an amount equal to that portion of his trading losses occasioned by defendant's actions.

Dr. Rolf placed a discretionary[6] account[7] with Blyth, Eastman,

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1. 570 F.2d 38 (2d Cir. 1978) (per Oakes, J.) *cert. denied*, 47 U.S.L.W. 3383 (Dec. 5, 1978).

2. Federal district courts have exclusive jurisdiction over all actions brought under the Securities Exchange Act of 1934 and the rules thereunder. 15 U.S.C. § 78aa (1970). The rules of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) were promulgated under authority granted in §§ 6 and 19 of the Act; 15 U.S.C. §§ 78f, s(b)(1) (1970). And although these rules are not "rules thereunder," they are sufficient to give federal jurisdiction. Buttrey v. Merrill, Lynch, Pierce, Fenner, & Smith, Inc., 410 F.2d 135, 142 (7th Cir. 1969), *cert. denied,* 396 U.S. 838 (1969). *See* Lowenfels, *Implied Liabilities Based upon Stock Exchange Rules,* 66 COLUM. L. REV. 12, 18-19 (1966). *But see* Lange v. H. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976), in which the court, in a startling opinion, held that it had no jurisdiction to consider a complaint based on a violation of NASD rules.

3. 425 U.S. 185 (1976).

4. The conflict among the circuits whether scienter is required for a violation of rule 10b-5 was settled when the Supreme Court declared that a private cause of action based on 10b-5 will not lie without an allegation of scienter, *i.e.* an intent to deceive, manipulate or defraud. *Id.* at 193. The Court explicitly refused to extend the scope of the rule to negligent conduct. *Id.* at 214. The principle that mere negligence will not support a cause of action has since been reaffirmed by the Court. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977).

5. The rule reads as follows:

> 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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 CF.R. § 240.10b-5 (1977).

6. A discretionary account gives the broker or investment advisor the power to buy and

Dillon & Co. (BEDCO). Responsibility for the account was eventually given to defendant Michael Stott who knew nothing about Rolf or his financial situation and who made no attempt to investigate them. On Stott's suggestion[8] Rolf hired Akiyoshi Yamada as an investment advisor and gave him full discretionary authority over the account. Stott offered a few recommendations to Yamada, but his major role during this period was to reassure Rolf about the investments Yamada was making for him. Yamada fraudulently manipulated the account, which declined over one million dollars.[9] Although BEDCO did not supervise the account, because Yamada had complete trading authority, it received over fifty-five thousand dollars in commissions and interest on Rolf's margin account.

Before Stott could be held liable for aiding and abetting[10] Yamada's fraud, plaintiff had to meet a three-part test. The court easily found that Yamada met the first requirement of an independent securities law violation.[11] The court also held that Stott rendered

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sell securities for the account. In a nondiscretionary account the investor selects his own securities and the broker merely executes the orders.

7. Rolf placed the account with Blyth, Eastman, Dillon & Co., Inc. (BEDCO) in 1963. When Stott assumed responsibility for it in 1969, it was worth over $1,000,000. Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. 1021, 1025-27 (S.D.N.Y. 1977).

8. Rolf believed Stott lacked the expertise to direct his account, but he agreed to keep the account at BEDCO if Stott would recommend an investment advisor. Stott, although he knew nothing about the account or Rolf, suggested two men, and Rolf interviewed and selected Yamada. *Id.* at 1027.

9. The district court referred to Yamada's handling of Rolf's account as a "gross fraud." *Id.* at 1043.

10. 570 F.2d at 47-49. "Aiding and abetting" has been defined in securities cases by reference to both criminal and tort law. SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975). The common-law definition, which is similar to the one used by the circuit court in *Rolf,* is as follows:

> 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. Restatement Torts § 876 (1939).

Fischer v. Kletz, 266 F. Supp. 180, 197 (S.D.N.Y. 1967).

The Supreme Court, in setting the standard for aiding and abetting the commission of a crime, said, "it is necessary that a defendant 'in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed.' " Nye & Nissen v. United States, 336 U.S. 613, 619 (1949) *quoting* United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1940). But in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191 n.7 (1976), the Court noted that it had not yet determined the requisites of the offense in the securities context. For general background for the problem, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution,* 120 U. PA. L. REV. 597, 620-45 (1972).

11. The district court found that Yamada committed two wrongs. First, he consciously defrauded Rolf by inducing him to purchase secretly-manipulated securities. Second, he breached his fiduciary duty owed to Rolf as his investment advisor. 424 F. Supp. at 1043.

In his dissenting opinion Judge Mansfield attempted to analyze the individual securities in Rolf's portfolio to show that many could not be considered unsuitable for him. 570 F.2d at 55 (Mansfield, J., dissenting). While it is true that some of the stocks selected by Yamada were profitable for Rolf, it is undeniable that Yamada used Rolf's money to further his extensive fraudulent scheme. *See* Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. at 1033-35.

substantial assistance to Yamada, the third requirement.[12] The significance of the decision lies in the court's determination that Stott had knowledge of Yamada's fraud, the second requirement.

The court held that conduct necessary to meet the scienter requirement in a private action under section 10(b) of the Securities Exchange Act of 1934[13] will also serve to prove knowledge on the part of the alleged aider and abettor.[14] If a broker owes a fiduciary duty to an investor, recklessness is a sufficient standard of conduct.[15] Reckless conduct is generally defined as

> [a] highly unreasonable omission, involving not merely simple or even inexcusable negligence, but 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 [he] must have been aware of it.[16]

This definition fails to add anything to this area of the law because "inexcusable negligence" and reckless conduct are practically indistinguishable. Furthermore, if the actor "must have been aware" of the fraud, a reason must exist why he was not actually aware of it. If this reason is that a broker breached a duty of inquiry imposed by a New York Stock Exchange (NYSE)[17] or National Association of Se-

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12. Stott processed the relevant orders and, through his continual reassurance to Rolf, prevented discovery of Yamada's fraud. 570 F.2d at 48.

In a footnote added to the opinion five months after it was initially released, the court indicated,

> This decision does not impose liability on a broker-dealer who merely executes orders for "unsuitable" securities made by an investment advisor vested with 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.

*Id. as modified by* [Current Binder] FED. SEC. L. REP. (C.C.H.) ¶ 96525 (1978). *See generally* Note, *The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct,* 29 VAND. L. REV. 1233 (1976).

13. 15 U.S.C. § 78j (1970).

14. 570 F.2d at 48.

15. *Id. cf.* S.E.C. v. Coven, [Current Binder] FED. SEC. L. REP. (C.C.H.) ¶ 96462 (1978), in which the Second Circuit extended its decision in *Rolf* and held that scienter is not required for aiding and abetting liability in an action under § 17(a) of the Securities Act of 1933. 15 U.S.C. § 77(q)(a) (1970).

> [The] test is whether an alleged aider and abettor "should have been able to conclude that his act was likely to be used in furtherance of illegal activity," in light of all the circumstances, including the nature of defendant's assistance to the primary wrongdoer, his participation in the challenged conduct, his awareness of the illegal scheme, and any duties to investigate or supervise that may be applicable.

[Current Binder] FED. SEC. L. REP. (C.C.H.) at 93,679.

16. Wolfson v. Baker, 444 F. Supp. 1124, 1134 n.15 (M.D. Fla. 1978) *quoting* Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976). *See also* Coleco Indus., Inc. v. Berman, 423 F. Supp. 275, 296 (E.D. Pa. 1976); S.E.C. v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1243 n.4 (S.D.N.Y. 1976), *aff'd,* 565 F.2d 8 (2d Cir. 1978). If the defendant genuinely forgot to make the disclosure or it never came to mind he would not be liable. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 n.20 (7th Cir. 1977).

17. *See* [1962] 2 NYSE GUIDE (C.C.H.) ¶ 2405.

Rule 405 — Every member organization is required through a general partner or an

curities Dealers (NASD)[18] rule, then he should be held accountable for this dereliction, which is the rationale the district court utilized for imposing liability against Stott for violation of these rules as well as for aiding and abetting.[19] The court of appeals, however, refused to face what it called the "thorny" question whether a private cause of action exists for a breach of these private rules and found liability only for aiding and abetting.[20]

NYSE rule 405[21] requires each member of the exchange to exercise due diligence to learn the essential facts about each customer and each person holding a power of attorney over a customer's account. The NASD Rules of Fair Practice[22] impose a duty to determine the suitability of a security for an investor after considering his financial situation and needs.[23] The lower court accepted Rolf's contention that if Stott had adhered to these requirements and warned Rolf of the nature of the securities, he would have never invested in them.[24]

Because the NYSE and NASD are private organizations,[25] it is questionable whether a private investor may sue for damages caused by a violation of these rules.[26] Although the court in the leading decision *Colonial Realty Corp. v. Bache & Co.*[27] denied a right of action for one rule because it was too vague, it laid down a test that can be used to answer the question.

The court must look to the nature of the particular rule and its

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officer who is a holder of voting stock 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 and every person holding power of attorney over any account accepted or carried by such organization, (2) supervise diligently all accounts handled by registered representatives of the organization.

*Id.*

18. *See* NASD Rules of Fair Practice, Art. III, § 2, NASD MANUAL (REPRINT) 2152 (1969).

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 security holdings and as to his financial situation and needs.

*Id. Cf.* 17 C.F.R. § 240.15b10-3 (1977) (SEC rule concerning suitability for nonmember brokers).

19. 424 F. Supp. at 1040-43.

20. 570 F.2d at 48 n.19.

21. *See* note 17 *supra.*

22. *See* note 18 *supra.*

23. "Information concerning financial situation and needs would ordinarily include information concerning the customer's marital status, the number and age of his dependents, his earnings, the amount of his savings and life insurance, and his security holdings and other assets." SEC Securities Exchange Act Release No. 34-8125, [1966-67 Transfer Binder] FED. SEC. L. REP. (C.C.H.) ¶ 77459.

24. 424 F. Supp. at 1040-43.

25. The NYSE and NASD are self-regulatory organizations authorized by 15 U.S.C. §§ 78f, 78o(3), 78s (1970).

26. *Compare* Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969) *and* Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974) *with* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) *and* Wells v. Blythe & Co., 351 F. Supp. 999 (N.D. Cal. 1972).

27. 358 F.2d 178 (2d Cir. 1966).

> place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.[28]

The lower court in *Rolf* reasoned that a private right of action should be permitted[29] because the SEC has enacted comparable regulations,[30] the rules are designed to protect the investor,[31] and the duties may be unknown at common law.[32]

It is often said that hard cases make bad law, but here the appellate court ignored the "hard case" and still managed to make bad law. The same result could have been reached in a way that would preserve aiding and abetting liability for a person with knowledge of the fraud and still provide defrauded investors with a cause of action against a broker who breached his fiduciary duty.[33] Instead the court permitted a cause of action against a broker who had no knowledge of the fraud and who had no effective method of acquiring such knowledge except from the primary wrongdoer. In dissent Judge Mansfield criticized this approach taken by the majority and referred to the decision as "virtually indistinguishable from that reversed in *Hochfelder.*"[34]

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28. *Id.* at 182.

29. 424 F. Supp. at 1041. *Cf.* Parsons v. Hornblower Weeks — Hemphill Noyes, [1976-77 Transfer Binder] FED. SEC. L. REP. (C.C.H.) ¶ 95,885 (existence of right of action under NYSE rule 405 does not imply a corresponding right under NASD rule).

30. 17 C.F.R. §§ 240.15b10-3, 240.15b10-4 (1977). *See* Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 890 (D. Conn. 1976) (promulgation of rules by the SEC is some evidence that duties imposed thereby are an integral part of SEC regulation). *But see* Piper, Jaffray & Hopwood, Inc. v. Ladin, 399 F. Supp. 292 (S.D. Ia. 1975).

31. Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678 (D. Wyo. 1975).

> Under such rules, the investing public is, in a very real sense, a third party beneficiary of the duties imposed upon those required to adhere to those rules. . . . The rules which are the subject of discussion here are not broad generalized "catch-alls" as in *Colonial Realty v. Bache & Co.*, 358 F.2d 178, above; rather they are rules which are quite precise in comparison and have among their purposes the protection of the investing public. . . . Both rules play integral parts in the protection of the investing public and are explicit in the duties they create. The protection of the investing public is enhanced, not diminished, by permitting a private action to be based on these rules; and such actions, where based on such explicit rules, further the purposes of these Acts. They do not merely vaguely adjure the broker to behave himself.

*Id.* at 683. *See* Ocrant v. Dean Witter & Co., 502 F.2d 854, 858 (10th Cir. 1974); Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969); Evans v. Kerbs & Co., 411 F. Supp. 616 (S.D.N.Y. 1976); Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974).

Other courts have held that the purpose of the rules is not to protect the investor but to protect the securities dealer. *E.g.* Nelson v. Hench, 428 F. Supp. 411, 419 (D. Minn. 1977); *cf.* Musser v. Bache & Co. [1977-78 Transfer Binder] FED. SEC. L. REP. (C.C.H.) ¶ 96,183 (NASD Rules are based on cooperative self-regulation that would be undermined by private suits).

32. Carroll v. Doolittle, 21 Misc. 2d 203, 191 N.Y.S.2d 398 (1959). *see also* Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine,* 1965 DUKE L.J. 445, 452 (suitability rule analogous to warranty of fitness for a particular purpose (U.C.C. § 2-315)).

33. *See also* Comment, *Establishment of Liability for Aiding and Abetting Fraud under Rule 10b-5 and the Common Law,* 25 U.C.L.A. L. REV. 862 (1978).

34. 570 F.2d at 52 (Mansfield, J., dissenting). Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *rev'd,* 425 U.S. 185 (1976), involved an accounting firm retained by a broker-

Actual knowledge of the fraud should be required before a party is liable for aiding and abetting a securities law violation.[35] Equitable principles demand that a person have knowledge that his actions are assisting a crime before he can be held accountable for it; nevertheless, a party should not be able to sit idly and ignore evidence of fraud if he stands in a fiduciary position. Ignorance of a fiduciary duty, however, is an independent wrong that can be remedied without recourse to the medium of an aiding and abetting action[36]—most easily by the recognition of a private right of action for breach of the NYSE or NASD rules.

In a sense this argument is merely semantic since in *Rolf* the result would have been the same under either theory of liability. But circumstances may arise in which the results differ. For example, if the securities had been manipulated by someone other than Yamada, but he, in good faith, made the same trades for Rolf, then Stott could not be liable to Rolf since there would have been no primary securities law violation attributable to Yamada; Stott could have prevented the loss, however, by fulfilling his duty and inquiring into the suitability of the securities for Rolf. It is inconsistent and inequitable to permit conduct leading to identical results to support liability in one instance and to go blameless in another. The court should have ignored the aiding and abetting liability and squarely faced the question of liability for breach of a fiduciary duty.

The court of appeals did redeem itself on the question of damages.[37] Rolf claimed he was entitled to recover his net trading losses and punitive damages.[38] Although the district court awarded only the commissions paid to BEDCO plus interest on the margin ac-

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age firm whose president defrauded the firm's clients. Ernst & Ernst was charged with failing to properly audit the brokerage firm and thus aiding and abetting the fraud. The plaintiff and defendant had no direct contact with each other.

*Hochfelder* is factually distinguishable from *Rolf*, in which the broker and the investor regularly communicated with each other, and the broker continually gave personal assurances as to the investments being made. Furthermore, policy reasons in favor of not holding the accountants liable cannot extend to a broker in constant contact with his client. *See* Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

35. *See, e.g.*, S.E.C. v. E.L. Aaron & Co., [1977-78 Transfer Binder] FED. SEC. L. REP. (C.C.H.) ¶ 96,043 (supervisor's knowledge of false statements by brokers sufficient for aiding and abetting liability). *See generally* Ruder, *supra* note 10 (knowledge required but scienter is incorrect concept).

36. Hanly v. S.E.C., 415 F.2d 589, 597 (2d Cir. 1969); Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. at 1036.

37. On the general issue of damages in securities cases see Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 FORD. L. REV.277 (1977) and Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093 (1977).

38. Punitive damages are not awarded in this type of case for two reasons. First, the suit itself provides sufficient deterrent value. *See* deHaas v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970), and cases cited therein. Second, the Securities Exchange Act itself limits recovery to "actual damages." 15 U.S.C. § 78bb(a) (1970). Some courts have construed this to prohibit punitive damages. Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

count, the appellate court reversed and awarded Rolf his net trading losses adjusted to reflect the overall decline in the market.[39] Unfortunately the court overcompensated Rolf by utilizing the following formula to determine the amount of damages: ascertain the time period when Stott had an effect on Rolf's account; subtract the final value of Rolf's portfolio from its initial value; then reduce the result by the stock market decline during this period.[40] A proper formula would reduce the initial value by the percentage decline in the market (thus giving the supposed value of the portfolio had Rolf done no trading) and then subtract the final value and award plaintiff the remainder. Notwithstanding this flaw, the court was correct in its award because the decline in the account as well as the loss of commissions can be directly attributed to Stott.

*Rolf v. Blyth, Eastman, Dillon & Co.*[41] is significant, not so much for its holding, but for the implicit warning it gives to the securities industry. Since conscious intent to deceive the investor is no longer a prerequisite to recovery, stricter control over discretionary accounts must be maintained or the firm[42] and its employees will find themselves liable to investors whose losses could have been avoided.[43] Correspondingly, an attorney who represents an investor may incorporate the reasoning in this opinion into an argument to impose liability on persons having little direct connection with the investor's losses. It remains to be seen how far the concept of recklessness will be extended toward negligence,[44] and thus, this area presents a fertile ground for future litigation.

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39. 570 F.2d at 49.

40. Consider the following example: assume that the market declined by 25% during the relevant period and at the same time the investor's account declined from $100,000 to $20,000. If the court's formula is applied, the $80,000 loss is reduced by 25% to $60,000, which is awarded to the plaintiff. The proper formula would reduce the $100,000 to $75,000 and award plaintiff $55,000. The court's formula gives plaintiff a windfall of $5,000, which he would not have had if he had not traded at all.

41. 570 F.2d 38 (2d Cir. 1978) *cert. denied*, 47 U.S.L.W. 3383 (Dec. 5, 1978).

42. The district court found BEDCO liable on two grounds — respondeat superior and as a controlling person under § 20 of the Securities Exchange Act. 15 U.S.C. § 78(t) (1970). For purposes of the appeal, BEDCO conceded that if Stott was liable, it was vicariously liable as a controlling person. 570 F.2d at 48.

43. *See* Sansweet, *Broker Bribery: Investment Advisers' Fraud and Kickbacks Bring SEC Crackdown*, Wall St. J., Apr. 25, 1978, § 1, at 19, col. 3.

44. The definition of reckless should maintain a clear distinction between scienter and negligence. The difference is one of kind, not merely degree. Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977).

[Casenote by John C. Rodney].