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Rolf v. Blyth, Eastman Dillon & Co., 570 F. 2d 38 (2d Cir. 1978)

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CASE COMMENTS

Securities Regulation—The Extension of Potential Aiding and Abetting Liability to Broker-Dealers Under Rule 10b-5 of the Securities and Exchange Commission—*Rolf v. Blyth, Eastman Dillon & Co.*, 570 F. 2d 38 (2d Cir. 1978).

I. Introduction

In 1963, David E. Rolf opened a discretionary investment account with Blyth, Eastman Dillon & Co., Inc. (BEDCO), a broker-dealer in securities.[1] Prior to that time, Rolf had maintained non-discretionary accounts at several major brokerage houses and had made his own decisions with respect to securities transactions.[2] Prior to his association with BEDCO, his investment objective was capital gains first and security second.[3]

At BEDCO, Rolf's account was managed by S. Logan Stirling, a partner in the firm until his retirement in March, 1969. Upon Stirling's retirement, Rolf, an experienced and aggressive investor,[4] decided that Stirling's replacement, Michael Stott, was not sufficiently qualified to direct his account.[5] At Rolf's request, Stott supplied the names of two independent investment advisors who might satisfy Rolf's requirement of "an analyst with sufficient expertise to direct his investments."[6] Consequently, on May 9, 1969, he hired Akiyoshi Yamada, a highly regarded independent investment advisor.[7]

Rolf left his account with BEDCO but informed the firm by letter that Yamada had full authority to initiate transactions in the account and that BEDCO should comply with Yamada's instructions in every respect.[8] Transactions were to be traded through BEDCO if at all possible, and BEDCO was to receive a confirmation when they were handled through another brokerage house.[9] Rolf specifi-

1. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 41 (2d Cir.), *cert. denied*, 99 S. Ct. 642 (1978). Blyth, Eastman Dillon & Co., Inc. is the successor firm of Eastman Union Securities & Co., with whom Rolf originally opened the account.
2. Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1025 (S.D.N.Y. 1977).
3. *Id.*
4. 570 F.2d at 41; *see* 424 F. Supp. at 1025.
5. 424 F. Supp. at 1027.
6. *Id.*
7. 570 F.2d at 42.
8. 424 F. Supp. at 1028. As compensation, Yamada was to receive 10% of Rolf's capital gains.
9. *Id.* at 1028, 1030.

cally asked Stott to look after the account.[10]

From May, 1969, to March, 1970, the value of Rolf's portfolio declined from $1,423,000 to $446,000 under Yamada's management.[11] In July, 1973, Rolf filed suit against BEDCO, Stott, and Yamada, alleging that they had defrauded him in violation of the Securities Exchange Act of 1934, section 10(b),[12] and rule 10b-5 of the Securities Exchange Commission.[13] Rolf also alleged that the defendants had violated article III, section 2, of the National Association of Securities Dealers (NASD) Rules of Fair Practice[14] and rule 405 of the New York Stock Exchange (NYSE).[15]

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10. 570 F.2d at 42.

11. *Id.*

12. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970) 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—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

13. 17 C.F.R. § 240.10b-5 (1978) states:

> 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 operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

14. Article III, § 2 provides:

> 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.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. MANUAL ¶ 2152 (1973).

15. Rule 405 provides:

> Every member organization is required through general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to
>
> (1) Use 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 [and to]
>
> (2) Supervise diligently all accounts handled by registered representatives of the organization.

2 NYSE GUIDE (CCH) 3697 (1978).

The United States District Court for the Southern District of New York concluded that Yamada had indeed violated rule 10b-5 by fraudulently manipulating individual stocks in Rolf's account and by managing the overall account in a fraudulent manner through the purchase of unsuitable securities.[16] BEDCO and Stott were held liable by the district court for aiding and abetting Yamada's fraud. Furthermore, the district court implied a private cause of action against BEDCO and Stott under the NYSE Rules and the NASD Constitution.[17] The court awarded damages of $55,790, which represented the amount of commissions and interest paid to BEDCO for transactions in Rolf's account.[18] BEDCO and Stott appealed the district court's decision as to liability while Rolf challenged its measure of damages.[19]

The Second Circuit Court of Appeals affirmed the aiding and abetting charge against BEDCO and Stott and remanded the cause to the district court for recomputation of damages based on Rolf's gross economic loss.[20] The court also concluded that Stott's assurances to Rolf of his confidence in Yamada's investment decisions, his reckless disregard for the truth of the assurances, and his reckless disregard of the improper and fraudulent management of Rolf's account were "substantial causal factors" in the perpetration of Yamada's fraud.[21] Having found liability under the aiding and abetting theory, the court did not reach the issue of whether a private cause of action existed under NYSE or NASD guidelines. That issue remains unresolved in the Second Circuit.[22]

The decision by the Second Circuit in *Rolf* is without precedent. In upholding the judgment of liability against Stott and BEDCO, the court expanded liability under rule 10b-5, broadened the concept of aiding and abetting, further relaxed the scienter standard for 10b-5 violations, and created an intractable situation for the securi-

16. 424 F. Supp. at 1043.

17. *Id.* at 1043-44. BEDCO was liable under the doctrine of respondeat superior and the securities law doctrine of controlling persons liability, Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1970). *See* SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976) (respondeat superior); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975) (respondeat superior); Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974) (liability while in scope of employment).

18. 424 F. Supp. at 1045.

19. 570 F.2d at 41.

20. *Id.* at 48-49.

21. *Id.* at 44, 48.

22. *Id.* at 43 n.6. Judge Mansfield in dissent agrees that there should be no implied right of action under NYSE rule 405 or NASD art. III, § 2, but goes one step further in contending that these regulations should provide a measure of protection for brokers, as well as investors, against being victimized by unscrupulous customers. *Id.* at 56.

ties industry. The results of *Rolf* contravene the implied intent of recent United States Supreme Court decisions.[23]

II. AIDING AND ABETTING

Common law tort theory has significantly influenced the formulation and development of the concept of aiding and abetting.[24] The Restatement of Torts contains general guidelines which the courts have used in developing the required elements of this offense.[25] Section 876(b) of the Restatement states that for secondary liability (aiding and abetting), the accused must know that the other party's conduct constitutes a breach of duty and must give substantial assistance or encouragement to the other party's conduct. The circuit courts have built upon this standard, independently determining the elements necessary for an act to constitute aiding and abetting of a securities law violation. Though the required elements are not universally agreed upon, many similarities in approach do exist.[26]

In 1969, the Seventh Circuit, in the landmark case of *Brennan v. Midwestern United Life Insurance Co.*,[27] established liability for aiding and abetting a securities law fraud based on the defendant's active and knowing assistance in the commission of an independent securities law violation. Similarly, the Sixth Circuit requires that a party other than the accused commit a securities law violation, that the accused have a general awareness of his role in the improper activity, and that the accused knowingly and substantially assist in the violation.[28] The Third Circuit, using a similar test, requires "an independent wrong" and knowledge by the accused of the wrong's existence, rather than merely an awareness of a role in an improper activity.[29]

23. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Black & Sachnoff, *Aftermath of* Ernst & Ernst v. Hochfelder, in NEW TRENDS IN SECURITIES LITIGATION 179 (1977).

24. SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *See* 570 F.2d at 45; 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 (1972).

25. RESTATEMENT OF TORTS § 876 (1939).

26. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-95 (5th Cir. 1975).

27. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of securities laws).

28. SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974) (chairman of board of corporation engaged in borrowing funds was not aider and abettor of 10b-5 fraud when he had no knowledge of misrepresentations to lenders or did not knowingly assist in the deception).

29. Landry v. Federal Deposit Ins. Corp., 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

In *Ernst & Ernst v. Hochfelder,*[30] the Supreme Court declined an opportunity to delineate the necessary elements of aiding and abetting a 10b-5 violation. Instead, the Court further confused the issue by raising, and then leaving unanswered, the question of whether aiding and abetting liability was even appropriate under 10b-5.[31]

Since *Hochfelder,* the influential Second Circuit has continued to find aiding and abetting liability appropriate,[32] as have several other courts.[33] In *Rolf,* the court required the following elements for liability: (1) the commission of a securities law violation by a primary party, (2) defendant's knowledge of the fraud, (3) scienter on the part of the defendant, and (4) substantial assistance rendered by the defendant.[34] An examination of these elements as applied to the facts in *Rolf* reveals that the Second Circuit has made an unwarranted expansion of the principles underlying these elements and, consequently, has created a precedent which should not stand.

A. *Primary Securities Law Violation*

The commission of a securities law violation by a primary party is a prerequisite to any consideration of a defendant's liability as an aider and abettor. In *Rolf,* Yamada clearly violated rule 10b-5[35] by manipulating securities purchased for Rolf's account so as to increase their value artificially.[36] This much was conceded on appeal. These actions by Yamada, however, were not the fraud which Stott and BEDCO were found to have aided and abetted. In fact, they did not know of these manipulations or have any reason to suspect them.[37]

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30. In *Hochfelder,* 425 U.S. 185 (1976), the Court held that an action for civil damages could not be maintained under § 10b or rule 10b-5 without an intent to deceive, manipulate or defraud on the defendant's part since some element of scienter was necessary for liability. *See* Nye & Nissen v. United States, 336 U.S. 613, 619 (1949), for the Supreme Court's definition of aiding and abetting in the criminal area.

31. *See* text accompanying note 48 *infra.*

32. Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977). (knowing assistance of or participation in a fraudulent scheme gives rise to liability as an aider-abettor under 10b-5); Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977) (knowledge of investor-client relationship, knowledge of fraud, and action in concert with the investment advisor required for liability under 10b-5). *See also* Halcyon Sec., Inc. v. Chase Manhattan Bank, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,212 (S.D.N.Y. 1977).

33. *See, e.g.,* Wasson v. SEC, 558 F.2d 879 (8th Cir. 1977); Denny v. Carey, 72 F.R.D. 574 (E.D. Pa. 1976).

34. 570 F.2d at 46-48.

35. *Id.* at 44. It is well established that there exists a private cause of action for a violation of rule 10b-5. *Hochfelder,* 425 U.S. at 196 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971)).

36. 424 F. Supp. at 1034.

37. *Id.* at 1032.

The district court in *Rolf* viewed Yamada's 10b-5 violation as including not only his manipulations, but also his overall management of Rolf's account. Yamada's purchase of speculative stocks constituted a fraud.[38] Stott and BEDCO were found liable for aiding and abetting this fraud based on Stott's repeated assurances to Rolf of Yamada's competence and his failure to uncover and stop the mismanagement.[39]

In adopting this version of primary liability, the Second Circuit has unduly broadened rule 10b-5's prohibitions against manipulative and deceptive practices. The investment of a client's funds in securities which are not suitable for his investment objectives, while possibly a violation under another theory, should not be a violation of rule 10b-5.[40] The Supreme Court, in *Blue Chip Stamps v. Manor Drug Stores,*[41] as well as in *Hochfelder,* has given strong indications that it believes rule 10b-5 should be construed narrowly.[42]

In *Blue Chip Stamps,* the Court pointed out that civil remedies under section 10(b) and rule 10b-5 are judicially implied causes of action and, consequently, that their bounds should not be extended except as demanded by compelling policy considerations.[43] The underlying rationale for this policy is the vexatious nature of 10b-5 litigation.[44] The Court provided two examples. First, suits filed under an expanded version of the rule may be groundless but nonetheless may have settlement value because the allegations cannot be disproved before trial. This poses a possible disruption in normal business activities. Second, discarding strict rules of liability would throw open to the Court many hazy issues of historical fact which depend almost entirely on oral testimony.[45]

The decision in *Rolf* creates precisely these problems. A difficult, if not impossible, task presents itself to the court, which must now determine what an investor's objectives are and then discern what stocks are suitable for those objectives. To permit this cause of action under 10b-5 will increase tremendously the volume of litiga-

38. 570 F.2d at 43.
39. *Id.* at 44, 48.
40. Appellant's Petition for Rehearing at 3.
41. 421 U.S. 723 (1975).
42. The Court observed:

> While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good.

Hochfelder, 425 U.S. at 214-15 n.33 (quoting *Blue Chip Stamps,* 421 U.S. at 747-48).
43. 421 U.S. at 736-37.
44. *Id.* at 743.
45. *Id.*

tion from investors who believe, honestly or otherwise, that they have been victimized by their investment advisor.

In *Hochfelder*, the Court implied a narrow reading of 10b-5 by rejecting negligence as a measure of scienter in 10b-5 cases.[46] Although the rule itself does not preclude negligence, the Court required knowing and intentional misconduct for a violation of the rule.[47] The Court stated that:

> In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5, we 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.[48]

This puzzling footnote on the appropriateness of aiding and abetting liability, when read in the context of the balance of the opinion and *Blue Chip Stamps*, leaves one with the distinct impression that 10b-5 is designed for direct liability situations and is ill adapted to secondary applications. This is the position taken by the Securities and Exchange Commission as revealed in a staff memo published in response to the *Hochfelder* decision.[49] The Commission recommends that prosecutions under 10b-5 be pursued on a direct or indirect basis of liability and that the use of the aiding and abetting doctrine be avoided. The extension of 10b-5 liability, especially under aiding and abetting theory, is quite inappropriate in *Rolf* and, moreover, is in conflict with *Hochfelder*.

Even if the overall mismanagement theory of primary liability is not discarded on the basis of an unwarranted extension of the scope of 10b-5, the facts in *Rolf* do not support the contention that the stocks purchased for Rolf were unsuitable. Rolf was a speculator, not an investor. He had capitalized handsomely in the bull market of the midsixties and was not opposed to the purchase of speculative issues.[50] Rolf had stated in a letter to Yamada that, starting with roughly $2 million, he expected to wind up with $3.5 to $5 million

46. 425 U.S. at 193.
47. *Id.* at 197.
48. *Id.* at 191-92 n.7.
49. SEC. REG. & L. REP. (BNA) A-4 (May 26, 1976).
50. Mansfield in dissent describes Rolf as:

> [A] sophisticated investor in securities who was well aware of the difference between gilt-edge, relatively safe securities, on the one hand, and speculative "high fliers," on the other, and who had determined to get richer quick by choosing an aggressive program involving high-risk, OTC [over the counter] stocks in the hope that his adviser would succeed in picking a few big winners, but well aware of the pitfalls that were involved.

570 F.2d at 53 (footnote omitted).

within a year's time.[51] This is not the objective of a cautious investor.

The district court found that Rolf expected Yamada to take substantial risks for capital gains.[52] However, neither the district court nor the circuit court adequately considered these facts in judging the suitability of the stocks. Rather, both courts refused to look at the individual stocks involved and relied on the concept of an "all-encompassing web of fraud" to avoid the actual determination of suitability.[53] In his dissent in *Rolf,* Judge Walter R. Mansfield correctly suggests that the majority's conclusory treatment of this issue fails to establish a fraud which supports aiding and abetting liability.[54] He also argues that when the case is "stripped of the brooding omnipresence of Yamada's flagrant manipulations,"[55] nothing remains but unfocused allegations that Stott deceived Rolf. He concludes, "[i]n short, stripped of its conclusory characterizations, the majority opinion would barely make out a case of negligence on the part of Stott, much less one of his deliberately shutting his eyes to facts that would have revealed the 'fraud' on Yamada's part."[56]

The circuit court's lax treatment of suitability is also revealed in its treatment of the damages issue. The court suggested that Rolf receive his gross economic loss reduced by the percentage decline of a general stock index over the period.[57] This method of computing damages ignores the fact that Rolf was an aggressive investor. The stocks which he would have owned, regardless of the mismanagement, would have been much more volatile than those in a general market index. Consequently, any price declines on these stocks probably would have been greater than the declines in the index during the same period. To reimburse Rolf for these additional losses would be unjust and would reward his speculations.

B. Knowledge and Scienter

The second and third elements necessary for aiding and abetting liability in the Second Circuit are knowledge of the fraud and intentional actions by the defendant to further the fraud. Although these two concepts are distinct and should be considered separately,[58] the

51. *Id.*
52. 424 F. Supp. at 1028.
53. 570 F.2d at 47.
54. *Id.* at 50-51 (suggesting that investment in unsuitable stocks is too amorphous a concept upon which to base liability).
55. *Id.* at 51.
56. *Id.* at 52.
57. *Id.* at 49.
58. Ruder, *supra* note 24, at 631.

Second Circuit essentially merged the two and concluded that Stott's recklessness satisfied both requirements.[59] In fact, Stott was not reckless in failing to uncover Yamada's fraud and did not act with the required scienter.

Knowledge of the primary fraud is the most important element of aiding and abetting liability. Without it, no culpability can be established. Deviation from this requirement would impose unreasonable liability on secondary defendants.[60] The crucial prerequisite of knowledge has always been stressed in the Second Circuit and is firmly established in other circuits as well.[61] For example, in *Hirsch v. du Pont,*[62] the Second Circuit stated that liability under rule 10b-5 is the result of knowing assistance or participation in a fraudulent scheme. Knowledge of the fraud was also deemed an essential element in *Abrahamson v. Fleschner*[63] and in *Lowenschuss v. Kane.*[64]

In *Rolf,* the court relied on Stott's allegedly reckless behavior to satisfy the knowledge requirement. The court found Stott to be reckless in not uncovering the primary 10b-5 violation by Yamada, which was tenuously defined as an "all-encompassing web of fraud."[65] Stott's conduct was described by the court as highly unreasonable, departing to such a degree from the standard of ordinary care that the danger itself must have been either known to Stott or so obvious that Stott was somehow aware of it.[66] In labeling Stott's behavior as reckless under this definition, the Second Circuit has ignored the realities and complexities of the securities industry.

Under the circumstances, Stott did not digress from the standard of ordinary care to the point where his conduct could be labeled reckless. As Judge Mansfield pointed out in dissent, Yamada was a Harvard-trained specialist who was widely regarded as brilliant and had devoted his career to the analysis of small, relatively unknown firms.[67] Rolf hired him as an investment advisor to take advantage

59. 570 F.2d at 46-47.

60. Ruder, *supra* note 24, at 638.

61. Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 374 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974) (the one clear requirement for establishing aiding and abetting liability under 10b-5 is actual knowledge of the fraud); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 739 (10th Cir. 1974) (defendant's knowing assistance in fraudulent scheme gave rise to liability). *See also* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd,* 417 F.2d 147 (7th Cir. 1969).

62. 553 F.2d 750, 759 (2d Cir. 1977).

63. 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 436 U.S. 913 (1978).

64. 520 F.2d 255, 268 n.10 (2d Cir. 1975) (aider-abettor must assist principal with knowledge of material falsity or be reckless in determining existence of material falsity in registration statement, or knowingly and substantially assist the violation).

65. 570 F.2d at 47.

66. *Id.* (citing Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

67. 570 F.2d at 54.

of this expertise, hoping to capitalize quickly on speculative investments.[68] Furthermore, large brokerage houses such as BEDCO devote relatively little time to such special situations. Rather, they leave this area of the market to analysts such as Yamada. Most of their research is directed toward stocks which will appeal to the majority of their customers. Generally, these are stocks of widely known, heavily capitalized companies. To expect Stott and BEDCO to investigate the stocks being bought by an independent advisor such as Yamada, and to, in effect, second guess the advisor, is unreasonable.[69] In *Lanza v. Drexel & Co.*[70] the court stated that the duty to investigate did not extend to such extraordinary efforts.

Yamada independently made investment decisions based on his discretionary authority. Stott's alleged position of overseer "in the absence of some fixed, written delineation of authority and responsibility borders on the meaningless."[71] As Judge Mansfield states:

> [I]t would have been foolhardy for him to voice such a view to Rolf [that the stocks were "junk"], since Yamada, who was in command and had gained his reputation in part from his successful dealing in special situations, might well be possessed of detailed information not available to or obtained by BEDCO or Stott.[72]

Turning to the scienter requirement, the *Hochfelder* decision rejected negligence as the equivalent of scienter in 10b-5 cases.[73] As mentioned previously, the Second Circuit had held prior to *Hochfelder,* however, that recklessness *was* sufficient,[74] and presently interprets the Supreme Court's decision in *Hochfelder* as leaving this rule undisturbed.[75] In *Rolf,* the court stated that "at least where, as here, the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement."[76] Stott did owe a fiduciary duty to Rolf by way of the account relationship.[77] However, this duty did not extend to making determinations as to the suitability of stocks purchased by an independent investment advisor.

68. *Id.* at 53.
69. *Id.* at 54.
70. 479 F.2d 1277 (2d Cir. 1973).
71. 570 F.2d at 53 (Mansfield, J., dissenting).
72. *Id.* at 55.
73. 425 U.S. at 193.
74. Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (proof of willful or *reckless* disregard for the truth is necessary to establish liability under rule 10b-5) (emphasis added); *see* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363-64 (2d Cir. 1973).
75. 570 F.2d at 46.
76. *Id.* at 44 (footnote omitted).
77. *Id.*

The Second Circuit cites *Hanly v. SEC*[78] as an example of fiduciary duty in a broker-client relationship. In *Hanly,* a securities salesman misrepresented a known fact while inducing a customer to purchase stock. The court stated that, in such a situation, the salesman must disclose facts which he knows and which are reasonably ascertainable.[79] *Rolf* is clearly distinguishable from *Hanly.* Stott was not selling or promoting Yamada's services to Rolf, as Rolf had already independently contracted with Yamada. Stott misrepresented no known facts. His assurances were not baseless, as the court charged,[80] but were premised on the excellent reputation which Yamada enjoyed. Stott had no reason to suspect that Yamada's reputation was unwarranted.

The court stated that Stott had agreed to oversee Yamada's investments,[81] but this was not really Stott's function. Rather, Stott was responsible merely for handling operational aspects of the account transactions and for obtaining fair prices for stocks traded.[82] He had no expertise as an analyst which would have enabled him to oversee the quality of the purchases,[83] and he received no additional compensation for his advice. Stott had no economic interest at all in Yamada's recommendations. He received only fixed commissions for trading the securities—a service available at any brokerage house.

While the court equates Stott's "reckless" assurances to Rolf and his "reckless" failure to disclose Yamada's web of fraud with scienter, the facts themselves indicate that Stott's actions were at most negligent. And the Supreme Court held in *Hochfelder* that negligence does not constitute scienter in 10b-5 cases.

The court should have noted one of the conclusions stated in *Woodward v. Metro Bank of Dallas,*[84] a case which was cited frequently in *Rolf.* In *Metro Bank,* the Court decided that the scienter requirement scales upward when the activity in question is more remote.[85] In *Rolf,* the Second Circuit has, in effect, taken a step back

78. 415 F.2d 589 (2d Cir. 1969).

79. *Id.* at 597.

80. 570 F.2d at 47-48.

81. *Id.* at 45 n.10.

82. *Id.* at 54 (Mansfield, J., dissenting) (function performed by Stott and BEDCO custodial).

83. *Id.* at 43. Stott had referred to the stocks as "junk." However, the court placed insufficient weight on the fact that Stott did not know of Rolf's objectives or have analytical abilities upon which to base the remark.

84. 522 F.2d 84 (5th Cir. 1975).

85. *Id.* at 95 (bank was not liable for aiding and abetting borrower's fraud because bank was not aware of its role in the improper activity and did not knowingly render substantial assistance).

toward negligence in order to impute the intent necessary to impose aiding and abetting liability for securities fraud.

C. *The Impact of the Decision*

While securities laws should not be construed so narrowly that the results they were designed to attain cannot be achieved,[86] they should not be an "amorphous snare" for the guilty and innocent alike.[87] The court in *Rolf* has created such a snare.

By defining investments in unsuitable stocks as a violation of 10b-5 and by relaxing the scienter requirements, especially in the context of secondary liability, the court has unnecessarily expanded potential liability under 10b-5. As Judge Mansfield stated:

> [T]o hold that investment of a customer's account in unsuitable securities constitutes § 10(b) fraud and that a broker who executes orders given by an investment advisor pursuant to his discretionary authority may be held liable as an aider and abettor of such fraud, places an extraordinary and unconscionable burden on both the adviser and the broker.[88]

If the court felt compelled to find Stott and BEDCO liable, liability should have been based on violations of the NASD Rules of Fair Practice or rule 405 of the NYSE rather than on a strained interpretation of 10b-5. The dissent correctly made this distinction; the majority, unfortunately, did not.

By recognizing investment suitability as a basis of 10b-5 liability, the Second Circuit has placed itself in a position which is at best tenuous. It is difficult to establish just what an investor's objectives are and what risk-reward ratio he is willing to assume. It is nearly impossible to try to determine what stocks are suitable in meeting these objectives. These are subjective matters over which even experienced brokers and investment counselors disagree. It is only proper to ask how qualified federal judges are to make investment distinctions which even investment professionals hesitate to make.

Essentially, the Second Circuit has created a cause of action for account mismanagement. This decision will spawn precisely the type of litigation denounced so forcefully in *Blue Chip Stamps.*[89] In addition, as Judge Friendly stated in *SEC v. Texas Gulf Sulphur*

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86. Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 739 (10th Cir. 1974) (corporation and its president held liable for perpetrating a fraud on plaintiff by inducing plaintiff to purchase the corporation's stock).

87. 522 F.2d at 97.

88. 570 F.2d at 55-56 (Mansfield, J., dissenting).

89. 421 U.S. 723 (1975) (vexatious suits).

Co.,[90] an unduly expansive imposition of civil liability "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers . . . ."

In failing to grasp the basic relationships between the parties in *Rolf*, the court based its finding of liability on facts which, in the words of Judge Mansfield, "barely make out a case of negligence . . . ."[91] The securities industry will feel the most immediate impact of this decision. Independent investment advisors are major participants in the securities markets. They advise and manage innumerable accounts, ranging from individual trusts to multimillion dollar pension and profit-sharing funds. Since advisors are generally not broker-dealers, the transactions they generate must be traded through firms with that capacity. The accounts at the broker-dealer are normally listed in the customer's name, with the advisor retaining control over the account, just as in Rolf's situation. In most instances, the broker-dealer such as Stott has no intimate familiarity with the investment objectives of the customer. To place the burden of determining investment suitability on the broker-dealer is unwieldy, unwise, and unfair.

The Second Circuit, in establishing potential aider and abettor liability for broker-dealers in this situation, has created an atmosphere in which accounts, handled by advisors specializing in little known or fledgling companies, will be shunned. This will have the effect of reducing the flow of capital to developing sectors of the economy and may tend to accumulate capital in heavily traded stocks which are unquestionably suitable for most investors. In short, it will inhibit diversified economic growth and encourage increased economic rigidity.

Although the court denied a petition for rehearing in *Rolf*,[92] it did try to reduce the impact of its decision by amending the opinion in an order dated May 22, 1978.[93] Footnote 16A was added, which

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90. 401 F.2d 833, 867 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

91. 570 F.2d at 52 (Mansfield, J., dissenting).

92. No. 77-7104 (2d Cir., order July 3, 1978).

93. No. 77-7104, 77-7124 (2d Cir., order May 22, 1978). The full text of that order, not presented in the Federal Reporter 2d, is as follows:

ORDER AMENDING OPINION

> The opinion in the above entitled case is hereby amended by inserting Footnote 16A at the end of the first paragraph on slip opinion 905, after the word "fraud," said footnote reading as follows:
>
> > 16A. 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.

states that the 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. The court distinguishes this situation from that in *Rolf* by noting that Stott and BEDCO, as a supervisory authority, made unfounded assurances, and knew that some of the stocks purchased were unsuitable. For the reasons delineated earlier, these distinctions are a weak foundation on which to base such severe results. The arrangement between Rolf and Yamada certainly appeared to be one involving sole discretionary authority. There were no written instructions otherwise. Furthermore, Stott's assurances were not unfounded. They were based on his understandable reliance on Yamada's reputation. Moreover, the stock purchases by Yamada were not unreasonable or unsuitable in view of Rolf's ambitious objectives and Yamada's area of expertise. The tardy footnote, therefore, offers very little help in determining where the line is drawn as to broker-dealer liability as an aider and abettor under 10b-5. It certainly does little to soften the impact of the *Rolf* decision.

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