1982

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Eileen T. Walsh

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INTRODUCTION

A longstanding controversy in the area of securities law is the question of the vicarious liability of a broker or dealer for the unlawful acts of its registered representatives. Liability is often asserted under both the statutory provisions of the securities acts and the common law doctrine of respondeat superior. In injunctive and private damage actions in the federal courts, liability

1. 15 U.S.C. § 78c(a)(4) (1976) defines the term "broker" for purposes of the Securities Exchange Act of 1934 to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."
2. 15 U.S.C. § 78c(a)(5) (1976) defines the term "dealer" for purposes of the Securities Exchange Act of 1934 to mean any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.
Most brokerage firms transact business in the capacities of both broker and dealer. The term "broker-dealer" has evolved to designate a brokerage firm engaging in the business of buying and selling securities to or for customers.
6. 15 U.S.C. § 78u(d) (1976). In addition to its power to institute administrative proceedings against persons and firms registered with it, the SEC has specific statutory authority to bring an action in a federal district court to enjoin violations of the securities laws by any person. Id.
is imposed on a broker-dealer based upon direct violations of the antifraud provisions of the securities acts,8 aiding and abetting in a securities fraud,9 the common law doctrine of respondeat superior,10 and the statutory controlling persons provisions of the securities acts.11

The Securities and Exchange Commission (SEC) uses these same bases of liability in its administrative proceedings12 to impose liability on brokerage firms. The applicability and scope of respondeat superior and the controlling persons provisions in SEC administrative proceedings, however, is presently unclear due to

7. Any person who believes he has been injured due to a violation of the securities laws may bring a civil action in the courts for damages under various sections of the securities acts.


9. Section 876 of the Restatement of Torts provides:

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

RESTATEMENT OF TORTS § 876 (1939). In Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970), the court acknowledged that there is nothing in the Securities Acts or their legislative histories indicating a congressional intent to impose aiding and abetting liability. The court held, however, that an aider and abettor could be held liable under section 10(b) and rule 10b-5. Relying upon section 876 of the Restatement of Torts, the court found that “general principles of the law should continue to guide the development of federal common law remedies under section 10(b) and rule 10b-5.” Id. at 680. The court noted that liability for aiding and abetting based on common law tort principles was nothing more than a "logical and natural complement" to implying a private right of action under rule 10b-5, which also developed from general principles of tort law. See also SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975); Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973).

10. See supra note 5.

11. 15 U.S.C. § 77t(a) (Securities Act of 1933, § 15), 78t(a) (Securities Exchange Act of 1934, § 26) (1976). For the text of these provisions, see infra notes 35, 38. Control is not defined under the securities acts and the courts' analyses of the type of control required to bring one within the purview of the controlling persons statutes is uncertain. Two approaches toward defining controlling persons have developed. One standard defines control by status and requires no affirmative conduct on the part of the controlling person to impose liability. The second standard requires a showing of control in fact over the activity, transaction, or institution through which the perpetrator acted. For analyses of the concept of controlling person, see Reininger, supra note 3, at 230; Comment, A Comparison, supra note 3, at 156; Comment, Vicarious Liability of Controlling Persons, supra note 3, at 152; Comment, Secondary Liability of Controlling Persons, supra note 3, at 1345. For purposes of this article it is assumed that a broker-dealer firm falls within the definition of a controlling person.

12. Administrative proceedings are brought before an administrative agency as distin-
the congressional enactment of section 15 of the Securities Exchange Act of 1934,\(^{13}\) which provides for the registration and regulation of brokers and dealers and applies solely to administrative proceedings.\(^{14}\) Section 15(b)(4) grants the SEC power to institute administrative proceedings against a broker-dealer for willful violations of the securities acts under several specific bases of liability. A careful reading of the bases of liability available under section 15(b)(4) reveals their similarity to those traditionally relied upon in the federal courts. Subsection 15(b)(4)(D)\(^{15}\) is similar to the common law doctrine of respondeat superior, while subsection 15(b)(4)(E)\(^{16}\) appears analogous to section 20(a), the controlling persons provision of the Exchange Act.\(^{17}\)

No cases have yet addressed whether subsections 15(b)(4)(D) and (E) are the administrative equivalents of these traditional bases of liability. Until these sections are judicially construed, the question of whether they are narrower, broader, or equivalent in scope to the respondeat superior and controlling persons bases of liability remains unresolved. Moreover, their apparent equivalence raises the question of whether the SEC must rely exclusively upon the 15(b)(4) provisions in its proceedings, or whether the traditional bases of liability may also be employed.

This note will address the question of whether the SEC should be limited to subsections 15(b)(4)(D) and (E) when seeking to hold a broker-dealer vicariously liable in an administrative proceeding. First, the common law doctrine of respondeat superior will be examined. Next, the relationship between respondeat superior and statutory vicarious liability in nonadministrative proceedings will be discussed and extended to clarify the relationship between subsections 15(b)(4)(D) and (E). Finally, the legislative history and judicial interpretation of section 15(b)(4) will be reviewed and analyzed.

\(^{14}\) Id. § 78o(b)(4)(D)-(E). These provisions are commonly known as § 15(b)(4)(D)-(E) of the Exchange Act. For the text of these provisions, see supra notes 73,75.
\(^{17}\) 15 U.S.C. § 78t(a) (1976). See infra note 38 for the text of this provision.
THE COMMON LAW BASIS FOR BROKER-DEALER LIABILITY: RESPONDEAT SUPERIOR

The doctrine of respondeat superior posits the rule that a master, or other principal, must bear the responsibility for injuries caused by his servant acting within the scope of his employment.  It is premised on the principle that one who benefits from the acts of another must also bear the liability for any injuries resulting from such acts. The doctrine is not based on negligence or the failure to supervise, but is one of strict liability, precluding the defenses of good faith and due diligence. The unavailability of such defenses renders respondeat superior a very potent doctrine for the SEC and private securities plaintiffs, through which vicarious liability may be imposed for violations of the securities acts. Respondeat superior is thus an important basis of liability because it insures that a broker-dealer will be held accountable for the wrongdoing of its employees.

Both employer-employee and principal-agent relationships are included within the scope of this doctrine. The type of conduct giving rise to employer liability is liberally defined, and includes all actions falling within the legitimate scope of the employee's authority. Additionally, the employer may be liable for actions which, although not strictly within the "scope of employment," are facilitated by the existence of the employment relationship.

Rationales for the respondeat superior doctrine are founded on accepted notions of public policy, convenience, and justice. Underlying the application of the doctrine in an employment setting is a basic notion of fairness—that an employer who reaps benefits from the acts of his employee, or who facilitates the acts, should be held accountable for those acts. In addition, considerations of the greater ability of the master to bear the loss, his ability to spread

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18. E.g., Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970); 53 AM. JUR. 2D Master and Servant § 417 (1970); RESTATEMENT (SECOND) OF AGENCY § 216 comment a (1958).
20. 3 AM. JUR. 2D Agency § 261 (1962).
21. Id. §§ 261, 267.
22. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617, 623 (5th Cir. 1973); 3 AM. JUR. 2D Agency § 267 (1962); RESTATEMENT (SECOND) OF AGENCY § 216 comment a (1958).
the risk, and the increased incentive for the master to conduct his business properly justify the application of this common law doctrine.

Common law agency principles, including the doctrine of respondeat superior, have been applied frequently to various federal statutes by the courts. This application is particularly true in the area of corporate litigation and rests upon the authority of the federal courts to utilize common law principles to enforce federally created rights, when such principles are necessary to effectuate the congressional purpose. Common law respondeat superior has been applied specifically to the securities acts to hold brokerage firms vicariously liable in securities fraud cases for the acts of their broker-employees.

In addition, both the Securities Act of 1933 and the Securities Exchange Act of 1934 provide specifically for controlling person liability. These statutory provisions impose vicarious liability on broker-dealers for the wrongdoing of their registered representatives. A significant distinction between the statutory and the common law bases of liability is that the statutory provisions contain a good faith defense for the controlling person, while respon-

30. See, e.g., Henricksen v. Henricksen, 640 F.2d 880, (7th Cir.), cert. denied, 102 S. Ct. 669 (1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Holloway v. Howerd, 536 F.2d 690, 694-95 (6th Cir. 1976); SEC v. Management Dynamics, Inc., 515 F.2d 801, 812-13 (2d Cir. 1975); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 741 (10th Cir. 1974); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974). But see Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975) (holding that an employer's liability is not based on the doctrine of respondeat superior). Compare Reininger, supra note 3; Comment, Rule 10b-5 and Vicarious Liability, supra note 3; and Comment, Secondary Liability of Controlling Persons, supra note 3 (concluding that respondent superior and the controlling persons provisions are simultaneously available) with Comment, A Comparison, supra note 3 (concluding that controlling persons liability should be based exclusively on the controlling persons provisions).
deat superior does not. Thus, the common law doctrine of respondeat superior represents a much stricter standard of liability for a broker-dealer. Consequently, much attention has focused on the role of respondeat superior after the congressional enactment of statutory vicarious liability. The primary focus has been the relationship between the common law doctrine and the section 20 controlling persons provision of the Securities Exchange Act. An examination of this relationship provides an instructive analogy to the relationship, in the same Act, of subsections 15(b)(4)(D), which parallels respondeat superior, and 15(b)(4)(E), which parallels section 20.

THE STATUTORY BASIS FOR SECONDARY LIABILITY: THE CONTROLLING PERSONS STATUTES

Congress first provided for vicarious liability of controlling persons in section 15 of the Securities Act of 1933. This section provides that a controlling person is liable jointly and severally, and to the same extent as the controlled person, to any person to whom the controlled person is liable. Additionally, it provides a defense for the controlling person who had no knowledge of the violation or no reasonable grounds to believe that a basis for liability existed.

32. "Good faith" has been defined in the broker-dealer context as compliance with standards of reasonable care in the supervision of their employees. It is an objective test and represents the majority view. See Note, The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934, 48 N.Y.U. L. Rev. 1019, 1037 (1973).


35. Section 15 provides:

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 persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77i 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 grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Id. § 77o.

36. Id.
In the following year, Congress enacted the Securities Exchange Act of 1934 (Exchange Act).\textsuperscript{37} Section 20(a)\textsuperscript{38} of the Exchange Act is a controlling persons provision which parallels section 15 of the Securities Act of 1933. Section 20(a) also provides that a controlling person is liable, to the same extent as the controlled person, to any person to whom the controlled person is liable.\textsuperscript{39} Consistent with section 15 of the 1933 Act, section 20(a) of the Exchange Act also contains a defense for controlling persons, precluding the imposition of strict liability. Thus, under section 20(a), a controlling person who acts in good faith and does not induce the violation will not be held liable. Congress did not, however, expressly address the issue of the continued viability of respondeat superior in securities litigation. Predictably, this issue became controversial.\textsuperscript{40}

In attempting to resolve the competing tensions between those who argue that liability can be established solely under the controlling persons provisions, with their respective defenses, and those who favor establishing strict liability under respondeat superior, courts have focused on the legislative history leading to the enactment of the controlling persons statutes. The Second Circuit adopted this approach in SEC v. Management Dynamics, Inc.,\textsuperscript{41} an SEC enforcement action for injunctive relief. In Management Dynamics, the court upheld an injunction against a broker-dealer whose vice president had issued fictitious quotations to create a false impression of interest in a particular stock.\textsuperscript{42} The firm argued that its liability should be measured under the controlling person provision of section 20(a). The SEC argued, however, that respondeat superior was the appropriate basis for imposing liability on the broker-dealer.\textsuperscript{43}

\textsuperscript{37} Id. § 78.
\textsuperscript{38} Id. § 78t(a). This section provides:

\begin{quote}
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.
\end{quote}

\textsuperscript{39} Id.
\textsuperscript{40} See cases cited supra note 33.
\textsuperscript{41} 515 F.2d 801 (2d Cir. 1975).
\textsuperscript{42} Id. at 805.
\textsuperscript{43} Id. at 812.
The court analyzed the legislative history of the controlling persons provisions and indicated that, before common law agency principles could be statutorily preempted, the court must find by "clear evidence" that Congress intended to replace respondeat superior with the controlling persons provisions. Failing to find such clear evidence, the court stated that the legislative history of the provisions "gives no indication that Congress intended them to govern employer liability." It determined that Congress, by enacting sections 15 and 20(a), sought to expand rather than narrow the scope of employer liability under the securities laws. This expanded scope imposes liability on a firm's controlling shareholders or officers who would otherwise escape liability under agency principles because they do not fall within the traditional employer-employee relationship. The court indicated that control is broadly defined "to reach prospective wrongdoers rather than permit the escape of those who would otherwise be responsible for the acts of their employees." Further, in the court's opinion, the statutory provisions represented an expansion of liability to reach those who attempt to escape liability by acting through "dummy" directors. Thus, the court held that section 20(a) did not supersede common law respondeat superior, and that both theories were, in fact, concurrently available to impose vicarious liability.

44. Id.
45. Id. The court drew this conclusion, noting:

The legislative history of § 20(a), and of its analogue in the Securities Act of 1933, § 15, gives no indication that Congress intended them to govern employer liability. Section 15 had its genesis in the concern that directors would attempt to evade liability under the registration provisions by utilizing "dummy" directors to act in their stead. S.Rep.No.47, 73d Cong., 1st Sess. 5 (1933); H.R.Conf.Rep.No. 152, 73d Cong., 1st Sess. 27 (1933). And § 20(a) was consciously modeled after § 15 of the 1933 Act. As Thomas C. Corcoran, one of the authors of the 1934 Act, testified before the Senate Committee:

Without reading those paragraphs [of what is now § 20], the first is taken verbatim from the Securities Act. The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section (citation omitted).

Id. at 812.
46. Id.
47. Id. at 813.
48. Id. at 812. The Fifth Circuit in Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980), confirmed the Second Circuit's interpretation of the legislative history of the controlling person provision when it stated: "The legislative history of §§ 15 and 20(a) demonstrates that Congress enacted those sections to address the specific evil of persons seeking to evade liability under the acts by organizing 'dummies,' that, acting under their control, would commit the prohibited acts." Id. at 1118. The court in Newton concludes that Congress did not intend to limit secondary liability for violations of the
on broker-dealers.\footnote{515 F.2d at 812.}

In a subsequent case, it was noted that such an expansion of liability, beyond that imposed under common law, should be accompanied by statutory defenses not available in an employer-employee context.\footnote{Brief for the United States as Amicus Curiae at 10, Henricksen v. Henricksen, 640 F.2d 880, (7th Cir.), \textit{cert. denied}, 102 S. Ct. 669 (1981).} In providing statutory defenses to controlling persons, however, the SEC contended that the congressional purpose of protecting the public can be preserved only if the employer continues to be subject to the strict liability imposed by respondeat superior.\footnote{\textit{Id.} at 11.} According to the SEC, the combination of the statutory provisions and the common law basis of secondary liability is needed to complete a framework of liability which can successfully effectuate this congressional purpose.\footnote{\textit{Id.} at 10.}

In addition to legislative intent, the court in \textit{Management Dynamics} articulated several other factors which influenced its conclusion that respondeat superior and section 20(a) are concurrently available to impose broker-dealer liability for violations of the securities acts.\footnote{515 F.2d at 812.} The court first emphasized the importance of the vice president's position in the firm and the apparent authority he derived from that position to the success of the scheme. The opinion also pointed to the clear language of the statute itself to support its conclusion that agency principles are available, noting that the word "person," a key term in the securities acts, is defined to include a corporation.\footnote{15 U.S.C. § 78c(a)(9) (1976) defines the term "person" to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."} The court reasoned that this language manifested a congressional intent to make agency principles available, since a corporation can act only through its agents. Thus, the language of the statute, in the court's opinion, supports the logical conclusion that agency principles are available in imposing employer liability.

In the 1980 decision of \textit{Marbury Management, Inc. v. Kohn},\footnote{629 F.2d 705 (2d Cir.), \textit{cert. denied}, 449 U.S. 1011 (1980).} the Second Circuit affirmed its earlier finding in \textit{Management Dynamics}. In \textit{Marbury}, the court of appeals allowed respondeat superior as a source of secondary liability in a rule 10b-5 damages action,
where an employee of a brokerage firm misrepresented himself as a registered representative of the firm. The court in *Marbury* noted that section 28(a) of the Exchange Act\(^5\) specifically provides that the rights and remedies created by the Act do not displace, but rather, supplement, all other rights and remedies that might exist at law or in equity.\(^6\) The court, therefore, affirmed the use of respondeat superior in actions under the Exchange Act to impose liability independently of section 20(a).

Courts have also considered the policies underlying the securities laws and have found that the congressional purpose was to protect unsophisticated investors from fraudulent practices.\(^5\) The Fifth Circuit, in *Paul F. Newton & Co. v. Texas Commerce Bank*,\(^6\) recognized this legislative concern, noting that most investors rely on the reputation and prestige of the brokerage firm they choose, and that it would contravene congressional intent to allow these firms to escape liability for the fraudulent practices of their employees.\(^6\) The court found it consistent with the remedial purpose of the securities acts that an employer be held liable under agency principles. This result, according to the court, recognized the importance of providing protection to the investing public.\(^6\) The court emphasized that imposing common law respondeat superior is not the equivalent of imposing an insurer's liability on an employer; the requirements of agency principles, that the agent act within the course and scope of his employment, and that he act within his actual or apparent authority, restrict the scope of the principal's liability.\(^6\)

The Supreme Court has not ruled on whether the use of the statutory basis of section 20(a) and the common law basis of respondeat superior to impose secondary liability is exclusive or concurrent. Although the appellate courts are not in agreement on this issue, the emerging majority of circuits which have considered the question, hold that agency principles and the controlling persons provisions are concurrently available to impose vicarious liability.\(^6\)

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\(^6\) 629 F.2d at 716.
\(^5\) See, e.g., *Paul F. Newton v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980).
\(^\) Id. at 1111.
\(^\) Id. at 1119.
\(^\) Id.
\(^\) Id.
\(^\) See cases cited supra note 32.
SECTION 15(b)(4) OF THE SECURITIES EXCHANGE ACT

The preambles of the securities acts indicate that the legislature intended to protect the public from fraud and unfair practices by providing for full and fair disclosure and regulation of the industry. Both securities acts are remedial and are to be construed broadly. Such broad construction accomplishes this congressional purpose of protecting the public, especially unsophisticated investors, from fraudulent practices.

Section 15 of the Exchange Act provides for the registration and regulation of brokers and dealers. Under section 15(b)(4) of the Act the SEC may sanction a broker or dealer for securities violations. The statute provides that the imposition of such sanctions must be "in the public interest." The language of section 15(b)(4) expressly provides that the SEC may sanction any broker or dealer not only for its own violations, but also for the violations of "any person associated with such broker or dealer." Thus, under this provision, a brokerage firm can be held directly accountable for the wrongdoing of its employees.

Broker-dealer activities giving rise to SEC sanctions are broadly defined in subsections 15(b)(4)(A) through (F). The broadest pro-
vision under which sanctions may be imposed is subsection D,\textsuperscript{73} which specifically addresses liability for various securities violations. Subsection 15(b)(4)(D), read together with the introductory paragraph to section 15(b)(4), imposes a standard of strict liability upon a broker or dealer for its own wrongdoing, or that of its employees. It makes no provision for any defenses such as good faith or adequate supervision of the employee. Thus, it appears to be the statutory equivalent of the common law doctrine of respondeat superior, through which the SEC can reach culpable brokers-dealers in its administrative proceedings. Still unresolved, however, is whether subsection D and respondeat superior are in fact equivalent, and whether the SEC may rely on respondeat superior in its proceedings should subsection D be construed judicially as narrower in scope than the common law basis of vicarious liability.\textsuperscript{74}

Subsection 15(b)(4)(E) imposes sanctions on any person who willfully contributes to another person's violation of the securities laws, and on those in a supervisory position who fail to reasonably supervise a violator.\textsuperscript{75} This provision permits the SEC to reach the supervisory level of personnel within a brokerage firm directly. Notably, subsection E includes a defense for the vicariously liable

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\textsuperscript{73} Section 15(b)(4)(D) provides:

has willfully violated any provision of the Securities Act of 1933 [15 U.S.C. 77a et seq.], the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.], the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

\textsuperscript{74} The scope of section 15(b)(4)(D) and whether it is equivalent to respondeat superior is an unresolved issue which is beyond the scope of this article. It should be noted, however, that the issue is a valid concern of the SEC in that, should it lose its ability to rely on respondeat superior, the SEC's power to sanction violators of the securities acts may be significantly diminished.

\textsuperscript{75} Section 15(b)(4)(E) provides:

has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has 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
person, who must demonstrate that established supervisory procedures were reasonably discharged.\textsuperscript{76} Thus, subsection E is similar to section 20(a) of the Exchange Act, which also imposes vicarious liability on a controlling person for the wrongdoing of a firm's employees, subject to the defenses of good faith and noninducement of the violation. The distinction between the two provisions is that section 20(a) is available to impose liability in actions in either the federal courts or in SEC administrative proceedings,\textsuperscript{77} while 15(b)(4)(E) is available exclusively in SEC proceedings.\textsuperscript{78}

Congress enacted subsections 15(b)(4)(D) and (E) for use solely in SEC administrative proceedings. Yet, the similarity between subsection 15(b)(4)(D) and the doctrine of respondeat superior, as well as the similarity between subsection 15(b)(4)(E) and the controlling persons provision of the securities Exchange Act, present the interesting question of whether respondeat superior and section 20(a) may also be used, either singly or concurrently, by the SEC as bases of liability in its administrative proceedings. Congressional intent concerning this issue is unclear.\textsuperscript{79}

A comparison of subsections 15(b)(4)(D) and (E) poses an additional problem. Since many actions brought under subsection 15(b)(4)(D) could be characterized as a failure to supervise, it could be argued that such actions should be brought exclusively under subsection 15(b)(4)(E) with its accompanying defenses.\textsuperscript{80} This argument, if successful, would preclude the stricter standard of vicarious liabil-

\textsuperscript{76} See also Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975). In this case the Ninth Circuit stated the rationale behind \S 15(b)(4)(E)'s requirement that a brokerage firm supervise those who personally deal with the investing public. \textit{Id.} at 1135. The court found that the financial gains for the broker-dealer and the representatives are directly related to sales. Additionally, the client relies on the representative for investment advice and the opportunity of the latter to take advantage of the client is ever present. Thus, holding the broker-dealer vicariously liable ensures diligence of supervision and control. The court concluded that the nature of the securities business requires that this rule be a public policy which should be strictly enforced by the courts. \textit{Id.}

\textsuperscript{77} 15 U.S.C. \S\S 77o, 78t(a) (1976). \textit{See supra} notes 35, 38.

\textsuperscript{78} \textit{Id.} \S 78o(b)(4). \textit{See supra} note 75.

\textsuperscript{79} \textit{See supra} note 30; \textit{see also supra} note 45 and accompanying text.

\textsuperscript{80} \textit{See supra} note 75.
ity under subsection 15(b)(4)(D) in administrative proceedings when failure to supervise is an issue.

**Legislative History of Sections 15(b)(4)(D) and (E)**

Sections 15(b)(4)(D) and (E) were added to the Securities Exchange Act in 1964.81 The House report, which accompanied the bill enacting these amendments, stated that the purpose of the bill was to implement the SEC recommendations for amendments to the securities acts.82 The SEC recommendations were developed in a two year study, commissioned by Congress, on the adequacy of the securities laws for the protection of investors.83 The House report indicated that one of the major objectives of this legislation was to strengthen the qualification standards and disciplinary controls with respect to security industry personnel.84 The SEC acknowledged that, although the securities laws were generally strong, some abuses did exist, necessitating additional controls and improvements.85 In its testimony before the House, the SEC stated that enactment of these amendments, including sections 15(b)(4)(D) and (E), would provide it with the power needed to protect the investing public adequately.

Against this background of the general purposes behind the enactment of sections 15(b)(4)(D) and (E), it is important to note that at the time these provisions were proposed, the SEC practice was to use respondeat superior as a basis of vicarious liability in its administrative proceedings.86 As early as 1945, the SEC would find a firm vicariously liable on the principle that "the willful violations by [the employee], committed in the course of his employment, constitute willful violations by [the firm]."87 This history could indicate that Congress was aware of the SEC's use of respondeat superior at the time sections 15(b)(4)(D) and (E) were enacted, and that it did not intend to limit that use as the result of the legislation. In addition, the Senate report on the amendment indicated that the purpose of section 15(b)(4)(E) was to allow the SEC to reach a firm's middle or upper level employees with super-

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85. Id.
86. See, e.g., E.H. Rollins & Sons, Inc., 18 S.E.C 347 (1945).
87. Id.
Visory responsibilities rather than the firm itself. In order to prevent those individuals from being held as absolute guarantors of their supervisees' conduct, the reasonable care defense was incorporated in that provision.

**Judicial Interpretation**

The question of whether section 15(b)(4)(E) displaces the doctrine of respondeat superior was directly addressed by the Sixth Circuit in the 1970 decision *Armstrong, Jones & Co. v. SEC.* This case was an appeal from an SEC administrative proceeding which resulted in sanctions of both the firm and its chief officer under section 15(c)(1) for its employees' wrongdoing. The SEC sanctioned the firm after it found that the sales manager and various salesmen made unsubstantiated predictions to induce customers to purchase stock, thus violating various sections of the securities acts. The brokerage firm did not seriously dispute the finding that unwarranted predictions had been made by its employees, but did contend, however, that the firm itself could not be found to have willfully violated the Act due to the unauthorized acts of its agents. The brokerage firm argued that a finding that it willfully violated the Exchange Act was equivalent to a finding that it failed to supervise its employees adequately. It contended that failure of adequate supervision was a separate ground for remedial action, to be brought only under section 15(b)(4)(E) of the Securities Exchange Act, and not under respondeat superior.

The appellate court disagreed, stating that the SEC had long asserted that a brokerage firm may be sanctioned for the willful violations of its agents under the doctrine of respondeat superior. The court stated that "the fact that Congress enacted an additional provision giving the Commission the power to impose a sanction on a broker-dealer for failure to adequately supervise its

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89. *Id.*
90. 421 F.2d 359 (6th Cir. 1970).
92. 421 F.2d at 361.
93. *Id.*
94. *Id.* at 362.
95. *Id.*
96. *Id.* The court cited the following as authority for this statement: *Cady, Roberts & Co.,* 40 S.E.C. 907, 911 (1961); *H.F. Schroeder & Co.,* 27 S.E.C. 833, 837 (1948). *Id.*
employees does not limit the Commission's power to discipline a broker-dealer for its employees' acts. In so stating, the Sixth Circuit squarely held that Congress did not intend to limit the SEC's use of respondeat superior by enacting section 15(b)(4)(E), and that both bases of liability were thus available in SEC administrative proceedings.

Armstrong was later cited by the Second Circuit in SEC v. Geon Industries, Inc., an injunctive action against a broker-dealer, in which the court refused to apply respondeat superior. In Geon, a registered representative of a brokerage firm was found to have improperly received inside information from the president of a company. The court upheld the trial court's finding that there was no failure to supervise and declined to issue an injunction, noting, however, that the facts presented a close question.

The SEC argued that pursuant to the decision in Management Dynamics, the brokerage firm should be held liable under the doctrine of respondeat superior even though there was no failure to supervise. The court, however, distinguished Geon and declined to extend to it the rule of Management Dynamics. The distinction made was that Management Dynamics involved a high level employee who used both his position in the firm and his "apparent authority" from the firm to accomplish his fraudulent acts. Geon, on the other hand, did not involve a high level employee, but only a registered representative, who made no special use of his connection with the brokerage firm. The Geon court concluded that while an injunction was an appropriate remedy in Management Dynamics, the differing circumstances in Geon did not warrant such relief. The Second Circuit, therefore, declined to apply to Geon its rule of Management Dynamics, that even absent a finding of a failure to supervise, respondeat superior was a theory of liability available to the SEC.

In Management Dynamics and Geon, the Second Circuit, rather
than positing a general rule of law, specifically indicated that each holding was confined to the facts of the case at bar. Although neither court directly addressed the availability of respondeat superior in an administrative proceeding involving a failure to supervise, the analysis in *Geon* is nonetheless instructive, because it reveals the factors which a reviewing court might weigh in determining whether the use of respondeat superior is an appropriate basis of liability in an SEC proceeding.

Although the court declined to pass on the validity of the *Management Dynamics* holding, it acknowledged the wide latitude of sanctions available to the SEC which a federal district court considering injunctive relief does not enjoy.\(^{105}\) The court noted that through the sanctions imposed in its administrative proceedings the SEC could affect practices and procedures throughout the entire industry.\(^{106}\) The flexibility inherent in these proceedings, the court commented, enabled the SEC to make a much greater impact on the industry than that which could be accomplished by a single court injunction, affecting only a limited number of parties.\(^{107}\) The *Geon* court declined to issue an injunction in this case because, in the court's view, the facts did not justify the harsh result.\(^{108}\)

Another factor considered by the *Geon* court was that the firm played merely an attenuated role in the violation; the representative had made no special use of his connection with the firm, and ordinary commissions were the only profit the firm realized.\(^{109}\) The court balanced the need for an injunction in these circumstances with the potentially harsh consequences to the firm, and held that once it was determined that the brokerage firm exercised reasonable supervision, no injunction should be issued.\(^{110}\)

Recognizing the potentially harsh consequences, the *Geon* court refused to apply a strict liability doctrine where the penalty was harsh, the justification slight, and the policies of the securities acts not furthered. The *Geon* decision indicates, however, that the courts may be more receptive to the use of respondeat superior in

\(^{105}\) *Id.* at 54.

\(^{106}\) *Id.* at 55.

\(^{107}\) *Id.*

\(^{108}\) *Id.* If an injunction had issued, for example, the brokerage firm could easily be held in contempt for the actions of another of its registered representatives regardless of the adequacy of supervision. *Id.*

\(^{109}\) *Id.*

\(^{110}\) *Id.*
administrative proceedings brought under section 15(b)(4). But even in that context, the courts will carefully scrutinize the rationale for invoking the doctrine and the appropriateness of the sanction to the wrongdoing.

A recent Seventh Circuit decision provides several additional factors for the courts to weigh in assessing the applicability of the statutory and common law bases of liability. *Henricksen v. Henricksen*,111 involved a private damage action in which the plaintiff brought a securities fraud suit against her former husband, a registered stockbroker, and his former employer, the investment firm of Smith, Barney, Harris, Upham & Co., Inc. (Smith Barney). The plaintiff, Wendee Henricksen, alleged that the investment firm was liable under both section 20(a), the statutory controlling persons provision, and the common law doctrine of respondeat superior for conversion and fraudulent mismanagement due to its failure to supervise.

The court held that the firm was in fact liable under section 20(a) as a controlling person.112 The court found that Smith Barney was not reasonably diligent in its supervision of its representative, and consequently, could not meet the good faith defense of section 20(a).113 In finding liability, the court focused on the fiduciary relationships between the brokerage firm, its representative, and its customer. The court found that Smith Barney had a fiduciary duty directly to its customer which encompassed a duty to supervise its employees.114 That the account in this case was discretionary as well as employee related, the court stated, did not in any way relieve Smith Barney of its duty to supervise its employees, but, to the contrary, enhanced that duty.115 The opinion stated that the primary agency relationship created by the discretionary account was between the plaintiff and Smith Barney, with its agent acting on Smith Barney’s behalf.116 Mrs. Henricksen, therefore, had the right to rely on the brokerage firm’s fiduciary obligation to manage her account in accordance with her stated investment objectives. Moreover, she had the right to rely on the professional judgment of the firm’s representative “subject to the review and

111. 640 F.2d 880 (7th Cir.), cert. denied, 102 S. Ct. 669 (1981).
112. Id. at 887.
113. Id. at 885.
114. Id. at 888.
115. Id. at 887.
116. Id. at 886.
ultimate control of Smith Barney’s supervisory personnel.”

In addition to finding the brokerage firm liable under section 20(a) as a controlling person, the *Henricksen* court also held that the firm was independently liable under the common law theory of respondeat superior. Such liability again was based on Smith Barney’s fiduciary duty directly to its customer, which included the duty to supervise its representatives. The court concluded that statutory liability and common law liability were independent theories, simultaneously available in this action. Thus, section 20(a) did not preclude application of the strict liability imposed under respondeat superior.

The reasoning of the *Henricksen* court may be extended to clarify the bases of liability available in administrative proceedings brought under section 15(b)(4). *Henricksen* held that a fiduciary duty exists between the brokerage firm and the investor in a discretionary account. The court premised its holding on two facts: first, that such a relationship includes a duty to supervise; and second, that section 20(a) and respondeat superior, each incorporating a duty to supervise, are independent bases of liability. Taking this second premise one step further, because section 20(a) and section 15(b)(4)(E) of the Exchange Act are parallel provisions, it is reasonable to conclude that section 15(b)(4)(E) would also be an independent basis of liability separate from that imposed by respondeat superior. Given that respondeat superior, too, has its statutory parallel in 15(b)(4)(D), it follows that the defense provided in section 15(b)(4)(E) would not preclude liability under section 15(b)(4)(D) in administrative proceedings.

**ANALYSIS**

A review of both legislative history and judicial analysis indicates that respondeat superior is available to the SEC in imposing secondary liability on brokerage firms in section 15(b)(4) administrative proceedings. The legislative history of sections 15(b)(4)(D)
and (E) indicates that these amendments are additional bases of liability, through which Congress intended to strengthen the SEC's power to adequately protect the investing public. Moreover, there is no clear evidence of congressional intent to replace agency principles with these amendments.

As the legislative history reveals, section 15(b)(4)(E) is an expansion of liability intended to reach supervisory personnel who are not technically employers.\(^\text{122}\) It is appropriate that this expansion afford the supervisor a defense which makes his liability commensurate with his actual role in the securities firm. The reasonable care defense is an appropriate concomitant to this expanded liability because Congress never intended that supervisory personnel should be subjected to the strict liability standards of respondeat superior. The underlying rationales of respondeat superior do not apply to supervisory employees.\(^\text{123}\) It is the firm, not the supervisor, that provides a wrongdoer with the position and authority that facilitates the wrongdoing. Additionally, it is the firm that realizes the benefits of the employees' services. Thus, the firm should be liable for any wrongdoing resulting from the employment relationship. The supervisor, who neither facilitates the wrongdoing nor benefits from it, is responsible only in a supervisory capacity and should be allowed the defense of having reasonably discharged his supervisory duties.

In contrast, it is also appropriate that the broker-dealer be held to the standard of strict liability imposed by agency principles because the firm realizes the benefits of an employee's services, and the employment relationship facilitates a representative's actions. In light of these considerations, the firm should be liable for its agent's actions under respondeat superior.\(^\text{124}\)

The clear language of the statute also supports the conclusion that agency principles are available in SEC proceedings. As noted in *Management Dynamics*,\(^\text{125}\) the specific language of a statute

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"principal." *Id.* at 437. Under the "shingle theory," a broker-dealer firm that hangs out its "shingle" as an expert in securities and offers advice to customers on their transactions will be held to violate the antifraud provisions of the securities acts if it doesn't make full disclosure of possible conflicts of interest or other facts material to the customer's investment decisions, when dealing with the customer.

121. 640 F.2d at 886.
122. *See supra* notes 82-84, 88-89 and accompanying text.
123. *See supra* notes 23-26 and accompanying text.
124. *Id.*
125. *See supra* notes 44-45 and accompanying text.
must be examined to determine a provision's applicability. Management Dynamics held that since for purposes of the securities acts the term "person" includes a corporation, and a corporation can act only through its agents, agency principles are available to the SEC in addition to the section 15(b)(4)(E) basis of liability. Furthermore, section 28(a) of the Exchange Act also bolsters the conclusion that respondeat superior is available in SEC proceedings by specifically stating that the rights and remedies created by the Act do not displace other rights and remedies which exist at law or in equity.

At least one court has held that the SEC may use respondeat superior in administrative disciplinary proceedings, and that such use is not limited by section 15(b)(4)(E). Application of respondeat superior has been cautious, however, and is premised upon certain factors which warrant its use. The courts have employed a balancing test in determining whether liability will be imposed on a brokerage firm under respondeat superior. They have balanced the hardship which results from court injunction, with the need for such relief. This balancing test demands that the court carefully consider the particular facts and circumstances before it, and that the relief granted be appropriate to the wrongdoing involved. Reviewing courts employing a balancing approach also scrutinize the agent’s capacity and authority within the firm and the extent to which his connection with the firm is used to accomplish the wrongdoing. Courts recognize that the investing public chooses a brokerage firm based upon its prestige and reputation. Accordingly, they have imputed an increasing degree of liability on the broker-dealer where the violator was a high ranking employee who used the firm's credibility to accomplish his wrongdoing. Therefore, both the status of the employee and the extent of the brokerage firm's involvement in its employee's wrongdoing weigh in the court's determination of broker-dealer liability under respondeat superior.

Most recently, an additional rationale for imposing vicarious liability on the broker-dealer was articulated by the court in Hen-
Holding that the statutory and common law bases of liability are independently available, the court found that a fiduciary relationship extends directly from the broker-dealer to the investor. This fiduciary duty serves as an unconditional basis of secondary liability enforceable under the doctrine of respondeat superior.

As the decisions indicate, the courts may be more receptive to the use of respondeat superior in administrative proceedings than in injunctive actions brought before the court. This stems from two essential differences between these proceedings. In an administrative proceeding, the SEC may use a broad range of remedies, and may effect changes in the industry as a whole. In contrast, a court considering injunctive relief is faced with the imposition of a harsh remedy whose impact is limited to the firm or firms involved. The inherent flexibility of administrative proceedings encourages a willingness on the part of the courts to impose vicarious liability on the basis of respondeat superior in those proceedings.

In a similar vein, it follows from the case law and the legislative history that sections 15(b)(4)(D) and (E) are concurrently available to find broker-dealer liability in SEC administrative proceedings. Marbury Management, Inc. v. Kohn lends support to this conclusion. The Marbury court noted that section 28(a) of the Exchange Act specifically provides that the rights and remedies created by the Exchange Act do not displace, but supplement, all other rights and remedies existing at law or in equity. This reasoning indicates that respondeat superior is available in administrative proceedings to impose liability for violation of the securities laws. It follows from this premise that if section 15(b)(4)(D) is the statutory parallel of respondeat superior, and respondeat superior is available in administrative proceedings independently of section 15(b)(4)(E), that section 15(b)(4)(D) is also available independently of section 15(b)(4)(E).

A comparison of the relationships between section 20(a) and respondeat superior and between sections 15(b)(4)(D) and (E) bol-

134. See supra notes 107-08 and accompanying text.
137. See supra notes 120-21 and accompanying text.
sters the conclusion that sections 15(b)(4)(D) and (E) are independently available to the SEC as bases of liability. The congressional intent underlying section 20(a) was to expand common law liability so as to reach those who would otherwise escape liability by being outside the traditional employer relationship. It is appropriate that the defenses of good faith and non-inducement of the violation should accompany this expanded liability as long as respondeat superior is applied to the actual employer relationship.\textsuperscript{138}

The legislative history, as interpreted by the Second Circuit in \textit{Management Dynamics}, reveals an apparent lack of congressional intent to replace agency principles with section 20(a).\textsuperscript{139} Moreover, the specific language of the provision, together with section 28(a) of the Exchange Act, support the conclusion that respondeat superior and the controlling persons provision are independently available to impose liability for violations of the securities laws.

The same analysis relied upon in \textit{Management Dynamics} supports the conclusion that sections 15(b)(4)(D) and (E) are also concurrently available to the SEC to find broker-dealer liability. This conclusion accords with the legislative intent that section 15(b)(4)(E) expand traditional liability to permit the SEC to reach supervisory personnel within a brokerage firm.\textsuperscript{140} As such, section 15(b)(4)(E)'s supervisory defense does not preclude either statutory or common law strict liability. The availability of all bases of liability accomplishes the congressional purpose of providing to the SEC the additional controls it needs to strengthen public protection in the securities industry.

\textbf{CONCLUSION}

Both legislative history and judicial analysis illustrate that statutory and common law bases of liability are all independently and concurrently available in SEC administrative proceedings. Neither the history nor the judicial interpretation of section 15(b)(4)(E) indicate that it was intended to supersede or restrict the application of respondeat superior in these proceedings. Similarly, section 15(b)(4)(E) does not limit the application of section 15(b)(4)(D), regardless of its similarity to respondeat superior.

\textsuperscript{138} \textit{See supra} notes 57-58 and accompanying text.
\textsuperscript{139} \textit{See supra} note 45 and accompanying text.
\textsuperscript{140} \textit{See supra} notes 46-88-89 and accompanying text.
In determining whether the SEC may continue to employ respondeat superior, independently of sections 15(b)(4)(D) and (E), reviewing courts should consider several factors. These include the harshness of the penalty, the justification for the remedy, and the effect of the doctrine on the policies of the securities laws, which must be broadly construed to protect the investing public. Further, the extent of the broker-dealer’s involvement in its employee’s wrongdoing, and the capacity of the employee involved within the firm must be examined.

Similarly, the SEC should examine these same factors before sanctioning a broker-dealer under respondeat superior. In addition, the SEC should articulate the rationale supporting its use of respondeat superior based upon the circumstances of each case.

Until sections 15(b)(4)(D) and (E) are judicially construed by the Supreme Court, the SEC should be able to continue to rely on all existing bases of liability. It should, however, exercise caution in its use of respondeat superior, observing those guidelines which the courts have articulated. This approach allows the SEC to use the broadest basis of liability available in its administrative proceedings to insure the adequate protection of the investing public.

EILEEN T. WALSH