UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 87-3837

KAY HOLLINGER, et al.,

Plaintiffs-Appellants

v.

TITAN CAPITAL CORP., et al.

Defendants-Appellees

On Appeal from the United States District Court
for the Western District of Washington

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND SUMMARY OF ITS POSITION

This is a private action brought against Titan Capital Corporation ("Titan"), a securities broker-dealer firm registered with the Securities and Exchange Commission, under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The plaintiffs claim that Titan is liable for damages resulting from the alleged securities fraud of Emil Wilkowski, a securities salesman of Titan.

The United States District Court for the Western District of Washington granted summary judgment for Titan. The court concluded,

inter alia, that Titan was not liable under Section 20(a) of the Act, 15 U.S.C. 78t(a), which makes a "controlling person" liable for the securities law violations of a "controlled person." 1/ The court held that Titan was not liable because: (1) Titan did not have "actual power or influence" over Wilkowski, largely because Titan had hired him as an "independent contractor," and Titan therefore had no duty to supervise him; and (2) plaintiffs had not shown that Titan was a "culpable participant" in the fraud, in part because the firm had rules to prevent such fraud and rules for supervising its salesmen's compliance with the securities laws.

The Securities and Exchange Commission disagrees with several aspects of the district court's decision. First, the district court was incorrect in concluding that an agreement making a securities salesman an "independent contractor," whatever its effect may be with respect to tax and state law, can alter the brokerage firm's status as a controlling person under Section

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1/ Section 20(a) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this title 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.

20(a) and eliminate its duty to supervise. Where a person sells securities on behalf of a broker-dealer firm registered with this Commission and is not himself so registered, the firm -- without whose registration the salesman cannot lawfully engage in the securities business -- has control over and a duty to supervise him irrespective of an independent contractor agreement. Registration of a broker-dealer, and supervision by such a firm over its salesmen, ensure that the public is protected in dealings with these persons. The district court's ruling would create a loophole, permitting a class of "independent contractors" to deal with the public without satisfying the stringent financial and competency requirements imposed by federal law.

Second, the district court improperly concluded that the burden of proof is on the plaintiffs to show that Titan was a "culpable participant" in the fraud. Under the plain language of Section 20(a), a plaintiff need prove only that the defendant was a controlling person and that the controlled person committed a securities violation. Once those requirements are satisfied, the burden shifts to the defendant to establish the defense provided under Section 20(a), namely, that the firm acted in good faith and did not induce the violation. This Court in certain previous cases recognized that the statute places this burden on the defendant. The district court, however, relied upon other cases in this Circuit which seemed to require the plaintiff to show the defendant's lack of good faith. The Commission disagrees with this approach.

Third, with respect to the element of good faith, the district court seemed to hold that a brokerage firm satisfies its duty to supervise merely by having in place a system of supervision. The court failed to recognize that it is also necessary to consider the adequacy of the firm's supervisory system and whether the firm adequately discharged its responsibilities under the system.

The Commission, the agency primarily responsible for the administration and enforcement of the federal securities laws, is concerned that the investing public will be adversely affected, both in private actions and in Commission proceedings, by an affirmance of the district court's conclusions on the foregoing legal issues. Private actions for damages, such as that brought by the plaintiffs here, serve as a "necessary supplement" to the Commission's own enforcement actions. See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985). In addition, since the concept of control, and the concomitant duty of a brokerage firm to supervise the persons it controls, are applicable in actions brought by the Commission, an affirmance here could have serious consequences for the Commission's own ability to protect brokerage firm customers. Accordingly, the Commission has a significant interest in the proper resolution of the legal issues raised in this appeal.

QUESTIONS ADDRESSED BY THE COMMISSION

1. Where a person sells securities on behalf of a broker-dealer firm registered with the Securities and Exchange Commission

and is not himself so registered, does an agreement making the salesman an "independent contractor" divest the firm of its control over and its duty to supervise him?

2. Does Section 20(a) of the Securities Exchange Act of 1934, which makes a controlling person liable for the securities law violation of a controlled person "unless the controlling person acted in good faith," require a plaintiff to prove the controlling person's lack of good faith?

3. May a brokerage firm establish that it satisfied its duty to supervise, and thereby acted in good faith, merely by having in place supervisory procedures, or must the procedures also be adequate and be reasonably enforced by the firm?

STATEMENT OF THE CASE

Facts

Titan is a broker-dealer firm registered with the Commission and a member of the National Association of Securities Dealers, Inc. ("NASD") (RE 59). 2/ In 1983, Titan entered into a relationship with Painter Financial Group, Ltd. ("Painter"), a financial planning firm, whereby Painter apparently became a branch office of Titan (RE 61-62). Pursuant to this affiliation, various employees of Painter, including Emil Wilkowski, became registered representatives of Titan (id.). 3/

2/ "RE" refers to the record excerpts filed by the appellants.

3/ The term "registered representative" includes a securities salesman who is registered with the NASD to sell securities

(footnote continued)

Titan and Wilkowski entered into a "Contractor's Agreement" which stated that Wilkowski would sell securities for Titan, with Wilkowski receiving 70-83% of the commissions generated by his sales (RE 314). The contract stated that Wilkowski was an "independent contractor" (RE 310-13), that Titan had "no right to control or direct [Wilkowski] in the sales of securities" (RE 311), and that Wilkowski "shall not be considered * * * as having an 'employee' status for any purpose" (RE 312). The agreement, however, also expressly reserved to Titan "the responsibility and right to perform such supervisory overviews required by the Securities and Exchange Commission" and other regulatory bodies (id.). The agreement also prohibited Wilkowski from placing securities transactions with any broker-dealer other than Titan (or any firm with dual registration or licensing agreements with

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3/ (footnote continued)

on behalf of a particular broker-dealer firm. See Schedule C (II)(1)(b) of the By-Laws of the NASD, NASD Manual (CCH) ¶ 1753.

In Wilkowski's application for registration with the NASD, Wilkowski did not disclose the fact that he had been convicted of forgery approximately 12 years earlier. When the NASD later discovered the convictions, Wilkowski explained that he did not disclose the convictions because he thought they were expunged from his record after he made restitution to the victims (which, in fact, had not been made) (RE 306-09, 316-23). The convictions occurred more than 10 years before the application, and thus did not operate as a statutory impediment to his registration. See Sections 3(a)(39), 15(b)(4)(B) and 15A(g)(2) of the Act, 15 U.S.C. 78c(a)(39), 78o(b)(4)(B) and 78o-3(g)(2). As a result, the NASD approved his application (RE 61-62).

Titan) (RE 313). In addition, Titan required the branch office where Wilkowski worked to carry the Titan logo and provided Wilkowski with Titan business cards and Titan stationery (RE 34, 315).

Prior to joining Titan, Wilkowski had become acquainted with plaintiffs Hollinger and D'Arcy (RE 66). After Wilkowski joined Titan, these two plaintiffs invested in securities (mostly mutual funds) through him (RE 67-70). These plaintiffs also formed a company, with Wilkowski having a one-third ownership interest, as a means for making investments (RE 65). In connection with their initial investments in mutual funds, Hollinger and D'Arcy opened accounts with Titan (RE 67, 69). Thereafter, Wilkowski persuaded them to deliver funds for further investments to him personally, in the form of either cash or checks made payable to Wilkowski (RE 68-70). Hollinger and D'Arcy delivered approximately $71,000 to Wilkowski, who stole those funds (RE 68). After these plaintiffs asked several times for receipts, Wilkowski prepared and sent false receipts on Titan stationery (RE 70-71).

The other two plaintiffs, Jones and Nissan, similarly delivered approximately $4,000 to Wilkowski personally so that he would invest the monies for them (RE 71). Wilkowski also stole that money (RE 73).

The Proceedings Below

In December 1984, the plaintiffs brought this action against Titan, Painter and Wilkowski alleging, inter alia, that Wilkowski,

as an agent of Titan and Painter, had violated Section 10(b) of the Securities Exchange Act and Rule 10b-5. Titan moved for summary judgment on this claim on the ground that Titan was not a "controlling person" of Wilkowski and therefore was not liable under the controlling person provisions of Section 20(a) for the fraud committed by Wilkowski.

The district court granted Titan's motion on two grounds. First, the court held that Titan did not have "actual power or influence" over Wilkowski because, under the parties' agreement, Wilkowski was an independent contractor free from supervision and control by Titan. 4/ The court noted that Wilkowski committed the fraudulent acts on his own, without utilizing a Titan account, and that the firm received no benefit from the fraud. The court concluded that, although Titan reserved the right to supervise Wilkowski and required Wilkowski to follow Titan's internal rules for branch offices, these circumstances did not establish actual power or influence over the salesman. The court concluded that "[w]ithout more, an agreement between an independent sales agent and a broker-dealer that the agent will effect buy/sell orders for securities exclusively through the broker-dealer is insufficient to establish actual power or influence" (RE 33).

4/ In so holding, the court adopted a position that Titan had not even urged in its motion papers. Titan had largely conceded that it had actual power or influence over Wilkowski, stating in its motion papers that "Titan supervised its representatives, including Wilkowski, in a number of ways" (RE 165).

Second, the district court held that Titan was not a "culpable participant" in Wilkowski's fraud. The court noted that, under Ninth Circuit law, a brokerage firm is deemed to "culpably participate" in its salesman's fraud if it fails adequately to supervise its employees. 5/ The court held, however, that the plaintiffs could not show that Titan had failed adequately to supervise Wilkowski's acceptance of funds for investment. The court stated, as a basis for its holding, that Titan had rules governing acceptance of payments for securities and for supervising a "contractor's" compliance with securities laws and regulations. 6/

ARGUMENT

I. A BROKERAGE FIRM'S DUTY TO SUPERVISE ITS SALESPERSONS CANNOT BE AVOIDED BY HIRING THEM AS INDEPENDENT CONTRACTORS.

A. Brokerage Firms Are Subject to A Well-Established and Long-Recognized Duty to Supervise Salespersons under Their Control.

Well-developed case law, both in private actions and in proceedings brought by the Commission, establishes that broker-dealers must supervise their salespersons. As the Commission has stated:

> Effective supervision by broker-dealers is a critical element in the regulatory scheme and

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5/ See Buhler v. Audio Leasing Corp., 807 F.2d 833, 836 (9th Cir. 1987).

6/ The court also stated that Titan was not culpable because: Titan had no knowledge of Wilkowski's fraud; it would have been virtually impossible for Titan to have prevented the theft, and to impose such an obligation would be to impose

(footnote continued)

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

Mabon, Nugent & Co., Sec. Exch. Act Rel. No. 19424 (Jan. 13, 1983), 26 S.E.C. Docket 1846, 1852. This Court likewise, in Zweig v. Hearst Corp., 521 F.2d 1129, 1135 (9th Cir.), cert. denied, 423 U.S. 1025 (1975), emphasized the importance of supervision:

> The opportunity and temptation to take advantage of the client is ever present. To ensure the diligence of supervision and control, the broker-dealer is held vicariously liable if the representative injures the investor through violations of Section 10(b) or the rules thereunder promulgated. The very nature of the vast securities business, as it has developed in this country, militates for such a rule as public policy and would seem to suggest strict court enforcement.

This Court noted in Zweig (id.) that the duty to supervise is expressly imposed in Commission disciplinary proceedings under

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6/ (footnote continued)

"insurer's liability"; and, although Wilkowski's sales were made under Titan's logo and the plaintiffs had had some direct dealings with Titan, plaintiffs "looked only to Wilkowski for guidance in their investments" (RE 34-35).

The plaintiffs moved for reconsideration of the court's decision, arguing primarily that Titan should have notified customers that Wilkowski had been convicted of forgery (RE 211). The court rejected the argument and, in addition, dismissed claims against Painter sua sponte (RE 39). The court later ordered a default against Wilkowski. Docket Entry No. 88.

Section 15(b)(4)(E) of the Securities Exchange Act, which authorizes the Commission to impose sanctions on a broker-dealer that has "failed reasonably to supervise" persons subject to its supervision.

Under the Securities Exchange Act, the supervisory obligation of a broker-dealer requires it to supervise persons subject to its "control." This principle has been recognized in numerous proceedings brought under the controlling person provision of Section 20(a) of the Act. See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Zweig v. Hearst Corp., 521 F.2d at 1134-35. The duty to supervise controlled persons has also been recognized, even apart from Section 20(a), in Commission broker-dealer proceedings by virtue of the fact that Section 15(b) authorizes the Commission in its administrative proceedings to impose sanctions on the firm for securities law violations by persons it controls. See Bond & Goodwin, Inc., 15 S.E.C. 584, 601 (1944); see also Reynolds & Co., 39 S.E.C. 902, 916-17 (1960); R.H. Johnson & Co., 36 S.E.C. 467, 486 (1955), aff'd 231 F.2d 523 (D.C. Cir.), cert. denied, 352 U.S. 844 (1956). 7/

7/ Section 15(b)(4) refers to "associated persons," a term defined in Section 3(a)(18) as including persons "controlled" by the broker-dealer. Prior to the Securities Acts Amendments of 1964, Pub. L. 88-467, 78 Stat. 565, the statute did not use the term "associated persons." Instead, Section 15(b) itself referred directly to "controlled persons." 49 Stat. 1377.

B. An Independent Contractor Agreement Does Not Affect a Brokerage Firm's Duty To Supervise.

The well-established duty of a brokerage firm to supervise its controlled persons cannot be avoided through an employment contract which makes a salesperson, who is not himself registered under the Act as a broker-dealer, an "independent contractor." Section 15(a) of the Act provides that a person cannot lawfully engage in the securities business unless he is either registered with the Commission as a broker-dealer or is an "associated person" of a broker-dealer. 8/ As noted, supra, n.7, the term "associated person" is defined in Section 3(a)(18), 15 U.S.C. 78c(a)(18), as including persons controlled by or employed by a broker-dealer. 9/ As a result, there are only two categories

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8/ Section 15(a) provides that:

> (1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

9/ Section 3(a)(18) provides:

> The term "person associated with a broker or dealer" or "associated person of a broker or

(footnote continued)

of persons who can lawfully engage in the securities business -- (1) registered broker-dealer firms and (2) their associated persons, who include controlled persons. Thus, the statute does not allow the existence of a third category of salespersons who can lawfully engage in the securities business while neither registered themselves nor under the control of a registered firm. See June 18, 1982 letter from the Commission's Division of Market Regulation to the President of the NASD, [1982-83] Fed. Sec. Law Rep. (CCH) ¶ 77,303.

The foregoing provisions ensure that customers will in all instances receive either the regulatory protections that result from the salesman being registered himself or the protections that stem from the salesman being supervised by a registered firm. In registering, a person must satisfy numerous requirements, including those relating to financial integrity, and must demonstrate knowledge of the securities markets. 10/ Where the salesperson is not

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9/ (footnote continued)

> dealer" means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer * * *.

10/ The Act and Commission rules require a registered broker-dealer to satisfy net capital requirements (Rule 15c3-1, 17

(footnote continued)

registered, and therefore does not himself afford those protections to customers, it is essential that the customer receive the assurances of expertise and financial strength that are provided by a registered firm that supervises him.

The district court's conclusion that a firm has no duty to supervise its independent contractor salespersons is inconsistent with this regulatory structure. Although the concept of an independent contractor salesman may have meaning for purposes of federal tax law or state law, a salesman's denomination as an "independent contractor" is irrelevant to a broker-dealer's status as a controlling person and its duty to supervise. Where a firm's salesman is not himself registered as a broker-dealer, he is an associated person of that firm subject to the firm's control, and the firm has a duty to supervise him. This duty extends to all securities activities of the salesman facilitated by his connection with the firm. 11/

10/ (footnote continued)

C.F.R. 240.15c3-1), maintain customer protection reserves (Rule 15c3-3, 17 C.F.R. 240.15c3-3), and be subject to inspections by the Commission and other regulatory bodies (Rule 15b2-2, 17 C.F.R. 240.15b2-2). In addition, a registered firm must satisfy requirements of self-regulatory organizations like the NASD, such as those relating to account approval, internal supervision, and qualification of individuals working for the firm. See, e.g., Schedule C (II) of the By-Laws of the NASD and Section 32 of the NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 1753, ¶ 2182.

11/ Even apart from the construction of the Act, which requires that unregistered salesmen be subject to supervision, the district court's conclusion that Titan did not have actual

(footnote continued)

The Commission has long taken this approach to salesmen denominated as "independent contractors." The Commission has made clear that, in order to protect the investing public, a brokerage firm that sells securities through an "independent contractor" is responsible for either assuring that the salesman is himself registered as a broker-dealer or assuming supervisory responsibility over him. 12/ Consistent with this position, the

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11/ (footnote continued)

power or influence over Wilkowski seems incorrect. Titan reserved such power or influence when it expressly reserved for itself the "right to perform such supervisory overviews required by the Securities and Exchange Commission." Titan also profited from Wilkowski's selling activities, prohibited him from selling securities for any other firm, directed the procedures at the branch office where he worked, and held him out to the public as being affiliated with Titan. In view of these circumstances, it is doubtful that Wilkowski was an independent contractor even under the common law. See Restatement (2d) Agency § 220(2) (1958).

The district court's conclusion is puzzling for two additional reasons. First, Titan did not dispute that it had actual power or influence over Wilkowski (see supra, note 4). Second, although the court cited Buhler v. Audio Leasing Corp., supra, to conclude that Titan's reservation of supervisory authority did not show actual power or influence, there is not, in fact, any mention in Buhler that the defendant brokerage firm there retained supervisory authority over its salesmen.

12/ The Commission's position was stated in the June 18, 1982 letter to the NASD and the other self-regulatory organizations, supra, p. 13. The NASD distributed the letter to its members, of which Titan is one. (See Affidavit of Sharon Pennell, Docket Entry No. 79). In addition, the NASD recently reminded its members that "[i]rrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered [i.e., NASD registration] for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member." NASD Notice to Members No. 86-85 (September 12, 1986) (emphasis in original).

Commission has brought administrative proceedings against, and imposed sanctions on, broker-dealers based on the violations of their independent contractor salespersons. 13/

The Commission's position reflects the realities of control. Where a firm's salesman is not himself registered as a broker-dealer, the firm in fact has control over him. Although the term "control" is not defined in the Act, a "control" relationship is not limited to a common law employer-employee relationship. 14/ This Court has interpreted control to mean "direct or indirect

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13/ E. J. Pittock & Co., Inc., Sec. Exch. Act. Rel. No. 19932 (June 30, 1983), 28 S.E.C. Docket 322; University Securities Corp., Sec. Exch. Act Rel. No. 16041 (July 20, 1979), 17 S.E.C. Docket 1372. Conversely, a firm may hire "independent contractor" salespersons if it agrees to supervise them. For example, broker-dealers have established subsidiaries to sell insurance-related securities, which subsidiaries are not registered as broker-dealers. Based on the broker-dealers' representations that they would consider the subsidiaries and their personnel to be "associated persons" and would assume responsibility for their supervision and control, the Commission staff has issued "no action" letters stating that it would not recommend that the Commission take enforcement action based on such arrangements. See Loeb Rhoades, Hornblower & Co. (available August 10, 1978); Merrill Lynch, Pierce, Fenner & Smith, Inc. (available June 20, 1970) (available on LEXIS).

14/ Section 20(a) was intended to extend liability to reach persons who might act through "dummy" corporations or other intermediaries. See Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d at 1115-16; SEC v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975); L. Loss, Fundamentals of Securities Regulation 446-47 (1983).

influence over the policy and decision-making process" of the controlled person. Kersh v. General Council of Assemblies of God, 804 F.2d 546, 548 (9th Cir. 1986), quoting Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 668 (9th Cir. 1978). Similarly, control has been interpreted "as requiring only some indirect means of discipline or influence short of actual direction * * *." Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

A firm that employs an unregistered salesman, whether or not as an independent contractor, has such indirect -- if not direct -- influence over the salesman. Since a salesman who is not a registered broker-dealer cannot legally engage in the securities business on his own, it is only through his firm's registration that the salesman has access to the trading markets. The firm's power to withdraw or restrict that access gives the firm effective control over the salesman, whether or not he is considered independent for any other purpose. 15/

15/ The district court's decision narrowly construing Section 20(a) is particularly troublesome in light of the fact that the Ninth Circuit, unlike other federal courts of appeals, has rejected application of the common law doctrine of respondeat superior in actions against broker-dealer firms under the federal securities laws. Compare Christoffel, 588 F.2d at 667 with In re Atlantic Financial Management, Inc., 784 F.2d 29, 32-35 (1st Cir. 1980), cert. denied, 107 S. Ct. 2469 (1987) and cases cited therein. Since respondeat superior liability is unavailable in this Circuit, it is especially important that controlling-person liability not be unduly restricted.

II. A PLAINTIFF IS NOT REQUIRED TO PROVE THAT A BROKERAGE FIRM "CULPABLY PARTICIPATED" IN ITS SALESMAN'S VIOLATION IN ORDER TO ESTABLISH THE FIRM'S CONTROLLING-PERSON LIABILITY UNDER SECTION 20(a).

The district court, citing prior cases in this Circuit, stated that a broker-dealer firm is not a "controlling person" under Section 20(a) unless the plaintiff proves the firm's "culpable participation" in the violation. 16/ The statute, however, does not place such a burden on the plaintiff. It provides that a "controlling person" defendant is liable "unless [he] acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Courts and commentators have recognized that the statute thereby premises liability on the control relationship alone, subject to the good faith defense. 17/ Thus, once the plaintiff shows that the defendant is a "controlling person," the statute places the burden of proof on the defendant to show his good faith. See Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980) ("The burden of establishing this defense to § 20(a)

16/ See Buhler, 807 F.2d at 835; Kersh, 804 F.2d at 549. Cf. Christoffel, 588 F.2d at 669 (adopting a "participation" requirement but not a "culpable participation" requirement).

17/ As a matter of statutory construction, where a statute includes a provision that a person is liable unless certain elements are established, the elements of the provision are "left for the adversary to advance as a defensive matter." 1A Sutherland, Statutes and Statutory Construction § 21.11 (4th ed., Sands rev. 1972). See also, Ross v. A.H. Robins Co., 607 F.2d 545, 556 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).

liability rested upon [the controlling person]"); Marbury Management, Inc. v. Kohn, 629 F.2d at 716; SEC v. Savoy Industries, Inc., 587 F.2d 1149, 1170 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979); Fey v. Walston & Co., Inc., 493 F.2d 1036, 1051-52 (7th Cir. 1974); Mader v. Armel, 461 F.2d 1123, 1126 (6th Cir.), cert. denied, 409 U.S. 1023 (1972). 18/

It has likewise been recognized by this Court that Section 20(a) requires the defendant to to prove his good faith. In Safeway Portland Employees' Federal Credit Union v. C. H. Wagner & Co., Inc., 501 F.2d 1120, 1124 (9th Cir. 1974), this Court said, in discussing the analogous controlling person provision of the Securities Act of 1933, 19/ that "[t]hose claiming the exemption have the burden of proving it." See also Zweig v. Hearst Corp., 521 F.2d at 1134-35. In the broker-dealer context, this Court explained, good faith is established when a firm shows that it "maintained and enforced a reasonable and proper system of supervision and internal control over controlled persons so as

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18/ See also L. Loss, Fundamentals of Securities Regulation 1179-80 (1983); D. Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. Pa. L. Rev. 597, 602 (1972).

19/ Section 15 of the Securities Act provides that any person that controls another person liable under Section 11 or 12 of that Act is also liable for the controlled person's violation "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. 77o.

to prevent, so far as possible, violations of Section 10(b) and Rule 10b-5." Id. See also Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438-439 (N.D. Cal. 1968), partially modified on other grounds, 430 F.2d 1202, 1211 (9th Cir. 1970); Jackson v. Bache & Co., Inc., 381 F. Supp. 71, 96 (N.D. Cal. 1974).

Recently, in 1986, this Court shifted the burden to the plaintiff to prove the defendant's culpability. The Court in Kersh, in an action under Section 20(a) that did not involve a broker-dealer, stated that the plaintiff must show the defendant's "culpable participation." Later, in Buhler, the Court extended this requirement to an action against a broker-dealer. In neither of these cases did the Court explain how such a requirement was consistent with the statutory language or with the prior case law establishing that a broker-dealer must prove good faith by demonstrating that it had a reasonable system of supervision.

This Court recently recognized that the "culpable participation" requirement seems to shift the burden and noted that, in adopting this requirement, this Court "overlooked" prior law as established in Safeway. See Orloff v. Allman, 819 F.2d 904, 906 n.1 (1987). Accordingly, we urge the Court to make clear that in an action based on Section 20(a), the defendant rather than the plaintiff bears the burden of proof as to the defendant's good faith or culpability. 20/

20/ The Third Circuit appears to be the only other circuit to have shifted the burden to the plaintiff by adopting a

(footnote continued)

III. THE DISTRICT COURT ERRED IN HOLDING THAT, MERELY BECAUSE A BROKERAGE FIRM HAS A PROCEDURES MANUAL AND SUPERVISORY PROCEDURES, IT CANNOT BE LIABLE UNDER SECTION 20(a).

In analyzing "culpable participation," the district court stated that "Titan had adopted rules for accepting payments and for supervising a contractor's compliance with securities laws and regulations" (RE 34). The existence of these rules, the court stated, was a reason not to hold Titan liable under Section 20(a). The court did not consider whether the rules were adequate or whether they were enforced.

The mere existence of compliance rules and procedures does not satisfy the duty to supervise. The courts and commentators have stated that a broker-dealer can establish the good faith defense only by proving that it "maintained and enforced a reasonable and proper system of supervision and internal control * * *."

20/ (footnote continued)

"culpable participation" requirement. That court, however, has only done so in the context of cases not involving broker-dealers. Moreover, the court adopted the requirement after observing that the legislative history of Section 20(a) indicated that the Section was not intended to create "insurer's liability," which would result if culpability were not part of the provision. Rochez Bros. Inc. v. Rhoades, 527 F.2d 880, 885, 889-91 (3d Cir. 1975). That conclusion is inaccurate: it is through the good faith defense that Congress avoided insurer's liability and provided for the concept of culpability. The Second Circuit at one time also seemed to require that the plaintiff prove "culpability." Gordon v. Burr, 506 F.2d 1080, 1085-86 (2d Cir. 1974). The Second Circuit's later decision in Marbury Management, Inc. v. Kohn, 629 F.2d at 716, however, correctly places the burden of proof on the defendant to show his good faith.

Zweig, 521 F. 2d at 1135. See also, Paul F. Newton & Co., 630 F.2d at 1120 (firm must show that it "diligently enforce[d] a proper system of supervision and control"); 1 Goldberg, Fraudulent Broker-Dealer Practices § 7.1 (1978) at 7-4 ("In order to qualify for this defense, the broker-dealer * * * must prove that the firm instituted, maintained and strenuously enforced a system of surveillance over its registered representatives in accordance with the firm's duty to supervise its employees.") Likewise, in light of the duty to supervise set forth in Section 15(b)(4)(E) of the Act, the Commission has stated: "Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised." Mabon, Nugent & Co., 26 S.E.C. Docket at 1852. See also Supervisory Responsibilities of Broker-Dealer Management, Sec. Exch. Act Rel. No. 8404, 33 Fed. Reg. 14286 (September 21, 1968) (the duty to supervise requires "broker-dealer managements to establish and carry out an effective supervisory system" and "assure that all supervisory functions are being carried out appropriately * * *"). 21/

21/ Section 15(b)(4)(E) itself emphasizes that procedures must be reasonable and must be carried out. The section provides that the Commission may impose sanctions on a person who

(footnote continued)

Accordingly, the district court erred by suggesting that the mere fact that Titan had rules shows that Titan fulfilled its duty to supervise. The court should have examined whether the firm's supervisory system was adequate and whether responsibilities under that system were reasonably discharged. 23/

21/ (footnote continued)

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

22/ We take no position on whether the record is adequate to find that Titan in fact maintained and enforced adequate supervisory and compliance procedures. The Commission disagrees, however, with the district court's conclusion (RE 34) that nothing can be done to prevent the type of fraud practiced by Wilkowski. By closely reviewing his accounts, including reviewing Wilkowski's outgoing correspondence to customers and possibly contacting Wilkowski's customers concerning the scope of their securities activities with him, the firm might have discovered the fraud or discouraged Wilkowski

(footnote continued)

CONCLUSION

For the foregoing reasons, the Commission urges this Court to hold that the district court erred in attributing significance to a salesman's status as an "independent contractor" for purposes of controlling person liability under Section 20(a). The Commission also urges that the defendant rather than the plaintiff bears the burden of proof as to the defendant's good faith or culpability under Section 20(a) and that, with respect to a good

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22/ (footnote continued)

from undertaking such fraud. Those procedures might have been particularly appropriate in light of his forgery conviction and the misstatements in his NASD registration application.

We note that the district court seemed to hold that Titan could not be liable because it lacked knowledge of Wilkowski's fraud (RE 34). A brokerage firm's lack of knowledge, however, should not relieve it of liability, since a firm might lack knowledge because it failed adequately to supervise. We also note that the court suggested that Titan did not "culpably participate" because the plaintiffs looked only to Wilkowski for investment advice (RE 34). There is, however, no element of reliance in Section 20(a), so the existence of control and the duty to supervise are unaffected by a customer's reliance on the particular salesman. Moreover, while a customer may rely upon a salesman for advice, a customer is likely to rely on the firm for other purposes, such as for assurances of financial strength and general reputation.

faith defense based on a broker-dealer's supervision, the firm must show that it maintained and enforced an adequate system of supervision.

Respectfully submitted,

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