

CATCHING THE MAN BEHIND THE MAN: WHY THE SEC AND FINRA SHOULD CAPITALIZE ON SECTION 20(b) TO PURSUE CONTROL PERSONS

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“Qui facit per alium facit per se.” (He who acts through another, acts himself.)¹

I. INTRODUCTION

This article sets forth a fully developed legislative history behind Section 20(b) of the Securities Exchange Act of 1934, a detailed summary of cases involving Section 20(b) claims, and analyzes the viewpoints of multiple commentators to find answers to the following questions:

- What does the legislative history reveal about the intent of the drafters of Section 20(b)?
- Why should the Sixth Circuit’s decision in *Sec. Exch. Comm’n v. Coffey* be overruled entirely?²
- Are Section 20(b) claims viable in light of the Supreme Court’s recent decision in *Janus Capital Group, Inc. v. First Derivative Traders*?³
- What elements are necessary to prove Section 20(b) claims?
- What kinds of Section 20(b) claims can we expect to see from the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC)?

Section 20(b), which has been rarely used by FINRA or the SEC, concerns the liability of controlling persons and unlawful activity that takes place through other persons.⁴

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¹ HENRY CAMPBELL BLACK, A LAW DICTIONARY CONTAINING DEFINITIONS OF THE TERMS AND PHRASES OF AMERICAN AND ENGLISH JURISPRUDENCE, ANCIENT AND MODERN 979 (2d ed. 1910).

² *Sec. & Exch. Comm’n v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).

³ *Janus Capital Grp.*, 131 S. Ct. 2296 (2011).

⁴ Securities Exchange Act of 1934 § 20(b), 15 U.S.C.A. § 78t(b) (2006).

II. LEGISLATIVE HISTORY

The following consists of a comprehensive timeline of the substantive legislative history behind Section 20(b) of the Securities Exchange Act of 1934 (“’34 Act”); however, duplicative, and patently irrelevant references to the other sub-sections in Section 20 have been omitted.

A. The Legislative History of the “Liability of Controlling Persons” Provision

Prior to delving into the legislative history, it is worth noting that Section 20(b) did not have a corresponding provision in the Securities Act of 1933 (“’33 Act”). One of the reports from the House of Representatives concerning Section 15 of the ’33 Act stated that the so-called “dummy provisions” were “calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other.”⁵ This later became the basis for Section 20(a) in the ’34 Act, which was modeled after Section 15 of the ’33 Act, but Section 20(b) was a novel regulation.

As of January 23, 1934, the draft of the “Stock Exchange Bill” did not yet contain a provision to address the liability of controlling persons, but this changed shortly thereafter on February 1, 1934, when a handwritten note contemplated, simply, “[l]iability of controlling persons” as a potential revision.⁶ However, on February 9, 1934, President Franklin D. Roosevelt submitted a “Recommendation to Congress for Enactment of the Act” with a draft bill containing the following provision:

LIABILITY OF CONTROLLING PERSONS

Section 19. (a). Every person who, by or through stock ownership, agency, or otherwise, or who pursuant to or in connection with any agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under any provision of this Act or of any rule or regulation made pursuant thereto 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.⁷

⁵ H.R. REP. NO. 73-152, at 27 (1933).

⁶ LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934 (Pub. L. No. 291, 73d Congress, 48 Stat 881, (1934), 15 U.S.C. § 78).

⁷ S. 2693, 73d Cong. § 19 (2d Sess. 1934) reprinted in 11 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 37-38 (2001).

During this same time leading up to President Roosevelt's recommendations, a different committee member, whose identity is unknown, drafted somewhat different language to address controlling persons, as follows:

LIABILITY OF CONTROLLING PERSONS

Sec. 22. Every person who, by or through stock ownership, agency, or otherwise, or who pursuant to or in connection with any agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under any provision of this act or of any regulation promulgated pursuant thereto or of any rule required by such regulation 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 and to any penalties to which such controlled person is liable, unless he shall sustain the burden of proof that he acted in good faith without knowledge that such controlled person was committing or was about to commit such violation.⁸

Nevertheless, Section 19 was later expanded to include sub-sections, including the earliest known version of Section 19(b):

(b) It shall be unlawful for any person directly or indirectly to do any act or thing which it would be unlawful for such person to do under the provisions of this Act or any rule or regulation thereunder through or by means of any other person who is controlled by such person by or through stock ownership, agency, or otherwise or through or by means of any other person who is controlled by such person and one or store other persons by or through stock ownership, agency, or otherwise for the purpose of avoiding any provisions of this Act or any rule or regulation made thereunder.⁹

On February 9, 1934, Senator Duncan Fletcher issued remarks on the introduction of S. 2693, as follows:

Section 19 provides that persons who control others subject to the provisions of the act and regulations thereunder shall likewise be subject themselves. Not only does it cover the usual devices,

⁸ See *supra*, note 7.

⁹ See *supra*, note 8.

such as dummy corporations, but provides that when a member of the immediate family of a person forbidden to make a given transaction in a security effects such a transaction, the person forbidden shall have the burden of showing that the transaction was not an attempted evasion of the act.¹⁰

In a letter dated February 14, 1934, Richard Whitney, the President of the New York Stock Exchange, sent a letter to the Presidents of all listed corporations describing the impact of the proposed “Securities Exchange Act” bill.¹¹ He commented on Section 20(b) as follows:

Sec. 19 (page 24) makes every person who controls another, through stock ownership, agency or otherwise or through any agreement or understanding, liable for the acts of the controlled person to the same extent as if such acts were his own. In like manner, the acts of any spouse or of a child or parent residing with a person may be imputed to such person for the purpose of determining liability under the Act.

Soon thereafter, on February 23, 1934, Mr. Whitney expressed another opinion about the provision:

Section 19 of the bill impose[s] liability upon persons controlling any other person liable under the provisions of the bill when such control exists through stock ownership, agency or otherwise or by any agreement or understanding. These provisions seem to apply more particularly to corporations and officers, directors and stockholders of corporations than to exchanges or brokers. There is, however, one extraordinary provision which might directly affect brokers.

In view of the numerous provisions of the bill, to which criminal penalties are attached, and the fact that a violation of many of them could occur through inadvertence, this provision, which makes a man responsible not only for his

¹⁰ See *supra*, note 6.

¹¹ Letter from Richard Whitney “To the Presidents of All Listed Corporations” (February 14, 1934) (identifying his concerns about the draft provisions of the ’34 Act, “which would seriously affect listed corporations and their officers, directors and principal stockholders”). http://sechistorical.org/collection/papers/1930/1934_0214_ExchangeWhitneyT.pdf (last visited on March 3, 2014).

*own acts, but for the acts of independent persons, may operate in a grossly unfair manner.*¹²

[Emphasis added.]

On February 27, 1934, Lowell R. Burch of the New York Airbrake Co. wrote a letter as follows:

Section 19 contains clauses imputing liability for the acts of so-called “controlled” persons, including not only those controlled by stock ownership or agency, but also a spouse, child, or parent residing with the person to whom liability is to be imputed in the absence of proof of nonapproval or that the transaction was not for the purpose of evading a provision of the act.¹³

On February 28, 1934, Sidney Blumenthal of Sidney Blumenthal & Co., Inc., wrote a letter stating:

Sec. 19, page 24: This section seems to be particularly dangerous to trustees handling investments assigned to them by persons who are at the same time officers or directors and who still have a right of joining with the trustee in an advisory capacity, possibly influencing their decision. Thus, the director or officer of a company owning securities may have deposited some of the securities in behalf of certain beneficiaries under trust agreements, and may exercise his knowledge and judgment in behalf of such trust beneficiaries quite differently from that with which he would view his own interests. It would seem that this section would make it inadvisable for any beneficiary of such trust to own any securities in the company in which one of the trustees may be interested, even though the trustee is fully familiar with, and knows all about this business, and knows very little about other businesses in which the beneficiary would otherwise have to be interested, if such a course were made necessary by the sale of

¹² *Stock Exchange Regulation: Hearings before the H. Interstate and Foreign Commerce Comm. on H.R. 7852 and H.R. 8720*, 73d Cong. 228 (1934) (statement of Mr. Whitney).

¹³ *Stock Exchange Practices: Hearings before the S. Banking and Currency Comm. on S. Res. 84 (72nd Congress) and S. Res. 56 and S. Res. 97 (73rd Congress)*, 73d Cong. 7022 (1934) (statement of Mr. Lowell Burch).

securities in the company of which the co-trustee is an officer, and the reinvestment of funds in other companies.¹⁴

On February 28, 1934, Thomas G. Corcoran, an attorney and one of the co-drafters of the '34 Act, observed that the purpose of Section 19 is "to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section."¹⁵ According to Mr. Corcoran, if a bank or a brokerage controlled a separate corporation that bought and dealt in securities, then the bank or brokerage would be responsible for the acts of the separate corporation.¹⁶ However, a controlling originating entity that set up a separate corporation and ceded control would not be subject to any liability under the act.¹⁷

On March 6, 1934, Frank R. Hope, President of the Association of Stock Exchange Firms, New York City, contended:

Section 19 is entitled "Liability of Controlled Persons" and contains drastic provisions making every person who controls another through stock ownership, agency or otherwise liable for the acts of the controlled person as if such acts were his own. What is meant by a controlled person is not described and, therefore, the full effect of this section cannot be understood. There are many liabilities established for individuals by the bill and to what extent an individual is a controlled person within the meaning of this section is difficult to understand.¹⁸

On March 8, 1934, a Memorandum (draft), of unknown authorship, suggested amendments to Section 19:

I would suggest that subsections (a) and (b) be redrafted and made specifically to cover (1) the controller of a dummy corporation or

¹⁴ *Stock Exchange Practices: Hearings before the S. Banking and Currency Comm. on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.)*, 73d Cong. 7267 (1934) (statement of Mr. Sidney Blumenthal, Sidney Blumenthal & Co.).

¹⁵ *Stock Exchange Practices: Hearings before the S. Banking and Currency Comm. on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.)*, 73d Cong. 6571 (1934) (statement of Mr. Thomas Corcoran, co-drafter of the Act).

¹⁶ *Id.* at 6572.

¹⁷ *Id.*

¹⁸ *Stock Exchange Practices: Hearings before the S. Banking and Currency Comm. on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.)*, 73d Cong. 6915 (1934) (statement of Mr. Frank Hope, President of Association of Stock Exchange Firms).

individual; (2) a principal who actually authorizes the transaction in question; (3) authorization given under circumstances not amounting to Agency. The difficulty with the present language is that it may include liability for unauthorized acts of an agent who has been chosen with reasonable care. On a literal construction, if the agent cannot sustain the burden of showing due care, the principal is automatically liable, regardless of his own good faith and due care.¹⁹

On April 3, 1934, a proposal to amend Section 19(b) was offered as follows:

(b) Amend to read: “It shall be unlawful for any person, for the purpose of avoiding any provision of this Act or any rule or regulation thereunder to do, directly or indirectly, through or by means of any other person who is controlled by or through stock ownership, agency, or otherwise by such person or by such persons and one or more other persons, or who is under such direct or indirect common control with such person, any act or thing which it would be unlawful for such person to do under the provisions of this Act or any rule or regulation thereunder.”²⁰

[Emphasis appears in the original.]

On April 30, 1934, Representative Sam Rayburn, from the Committee on Interstate and Foreign Commerce, presented a report on the Securities Exchange Bill with a recommendation that it be passed.²¹ In the version presented by the House, Section 19 concerned “Liabilities of Controlling Persons” and subsection (b) made it “unlawful for any person to do, through any other person, anything that he is forbidden to do himself.”²² Representative Rayburn’s report stated as follows:

¹⁹ Memorandum (draft) Suggested Amendments to the “present” Bill, LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934 (Pub. L. No. 291, 73d Cong., 48 Stat 881, (1934), 15 U.S.C. § 78).

²⁰ Memorandum Re Amendments to Draft of April 3, 1934 – (First Committee Print), LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934 (Pub. L. No. 291, 73d Congress, 48 Stat 881, (1934), 15 U.S.C. § 78).

²¹ H.R. Rep. No. 73-1383, at 26 (1934) *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 26 (2001).

²² *Id.*

In this section and in Section 11, when reference is made to “control”, the term is intended to include actual control as well as what has been called legally enforceable control (See *Handy & Harmon v. Burnet*, 284 U.S. 135 (1931)). It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.²³

On May 4, 1934, an amendment was offered by Representative Hollister to strike Section 19(a), which makes it an unlawful act if it is performed by a controlling person.²⁴ He proposed using the term agent instead of controlling person because he believed the phrase “controlling person” was nonsensical and had no legal precedent.²⁵ His other concern was that Section 19(b) would open the possibility of strike suits, “...to attack an honest man under this bill merely because he may have wealth, or because he might have some connection with a corporation which has made a report of some kind or another.” In spite of his comments, the proposed amendment was rejected, and as Representative Lea explained, **“the object of this provision is to catch the man who stands behind the scenes and controls the man who is in a nominal position of authority.”**²⁶ Representative Lea also clarified that relying on an agency theory will not accomplish the same thing – the rationale being that the dummy ought to be responsible because he is the real party in interest.²⁷

On May 11, 1934, a letter signed by a committee affiliated with the National Association of Manufacturers was read into the record: “This section should be substantially modified. Liability of a controlling person should be limited to cases where the controlling person makes use of other persons in order to evade the act.”²⁸ However, the Senate did not discuss the proposed

²³ *Id.*

²⁴ 78 CONG. REC. 8086, 8094 (1934) (statement of Rep. Hollister).

²⁵ *Id.*

²⁶ 78 CONG. REC. 8086,8095 (1934) (statement of Rep. Lea).

²⁷ *Id.*

²⁸ 78 CONG. REC. 8563,8581 (1934).

amendment and on June 6, 1934, the bill went into law and the language of Section 20(b), later codified as 15 U.S.C. § 78t(b), has remained the same since that time:

§ 78t. Liability of controlling persons and persons who aid and abet violations

(b) Unlawful activity through or by means of any other person

It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.

On May 12, 1934, Section 19 was renumbered and became Section 20 of the '34 Act.²⁹

III. ANALYSIS OF PERTINENT CASE LAW

A. *Prior Relevant Case Law Before the Securities and Exchange Act of 1934*

1. *Handy & Harmon v. Burnet*

In *Handy & Harman*, the Court examined whether the six majority shareholders who held 75% of the stock in the Handy & Harman Corporation “controlled” the 20% of stock owned by Hamilton & De Loss, Inc., a separate corporation.³⁰ The specific tax issue was whether the two corporations were affiliated within Section 240(a) of the Revenue Act of 1918.³¹ This arose because Hamilton, the president of Hamilton & De Loss, Inc., had pledged his shares to one of the majority stockholders as collateral for a loan.³² Also, the Court noted Mr. Hamilton had never opposed any of the majority shareholders.³³ Consequently, based on these facts, the Court concluded that Hamilton did not have legally enforceable control and the majority shareholders were the ones who exerted actual control.³⁴

²⁹ 78 CONG. REC. 8666,8708 (1934).

³⁰ *Handy & Harmon v. Burnet*, 284 U.S. 136, 138-39 (1931).

³¹ *Id.* at 138.

³² *Id.* at 139.

³³ *Id.*

³⁴ *Id.* at 140.

This case was an interesting choice for the drafters of the '34 Act to rely upon to distinguish between actual and legally enforceable control. Although this distinction has been used sparingly since that time, out of nine reported decisions, nearly all of which concern Section 20(a) claims, only one case involving a Section 20(b) claim mentions the concept of legally enforceable control.³⁵ In spite of this scant treatment, one commentator opined that in applying the logic behind the Court's decision with Section 20(b), "this indicates an intent to require some degree of realistic control, as would be provided by legal or actual control."³⁶

B. *Subsequent Private Actions Involving Section 20(b) After 1934*

There are four major cases evaluating Section 20(b) claims in varying degrees of depth that have been decided since 1967 and a summary of these decisions is set forth in chronological order. One of the issues arising in evaluating Section 20(b) claims is that it is frequently tacked on to discussions concerning Section 20(a). However, there are differences between the two subsections and the distinctions have not been consistently recognized by the courts and even commentators who often confuse the two provisions. Accordingly, other cases with minimal relevance and negligible treatment of Section 20(b) were consciously omitted.

1. *Myzel v. Fields*

Lakeside Plastics and Engraving Co. ("LPE") was organized in 1946 by cousins, Zelman and Clarence Levine, as a small plastics corporation to make advertising signs.³⁷ Upon its original issue there were 1,140 shares of common stock issued to some 17 persons, at a par value of \$50 per share.³⁸ In 1948, a sales agency, entitled Lakeside Plastics Sales Co. ("LPS") was organized by Orrin and William Levine, brothers of Clarence Levine, who were also original stockholders and directors of LPE.³⁹ "From 1953 to sometime in 1957, the stock of LPE became totally vested in the hands of the four Levines and [LPS]".⁴⁰ "By 1958,

³⁵ Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990).

³⁶ William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws-Aiding and Abetting Conspiracy*,

Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme, 14 J. CORP. L. 313, 357 (1989).

³⁷ Myzel v. Fields, 386 F.2d 718, 728 (8th Cir. 1967).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

640 shares of LPE were owned by LPS.”⁴¹ Around that time, a one-fourth interest in LPS was sold to Zelman and Clarence Levine.⁴² In 1961, LPE re-acquired 640 shares of its stock as part of a merger with Lakeside Properties, Inc. (“LPI”), and it then retired the shares.⁴³ The remaining 500 shares of LPE stock, then owned one-quarter each by the Levines, was in turn exchanged for 500,000 shares of [a newly formed corporation called Lakeside Industries, Inc. (LII)].⁴⁴ Thereafter, 150,000 additional shares of LII were offered for sale at \$9 per share.”⁴⁵

Although the company struggled from 1946 to 1951, it entered into a large contract in 1951.⁴⁶ Thereafter, in 1953, sales zoomed but the company failed to disclose it had made a \$30,000 profit.⁴⁷ The Myzel brothers were friends of the Levines.⁴⁸ Although the company’s sales and prospects were improving, they made the following representations to the shareholders: “(1) the stock was not worth anything, (2) the company was making no money, and (3) Myzel had sold his own stock.”⁴⁹

At trial, the court instructed that “the Levines were liable for the acts of [the Myzels] ‘if they knew or should have known’ that the Myzels were ‘purchasing’ the stock for the Levines ‘or with the intention of reselling’ to them.”⁵⁰ The appellees argued that “‘a plan’ existed to obtain the stock for the Levines, and ... that if such existed the Levines would be liable for any fraud that the Myzels committed.”⁵¹ The trial court emphasized that the Levines must ‘know and approve’ of the Myzel activities in order to be liable.⁵² The court added that there could be no liability of the Levines ‘if they had not sought to have the

⁴¹ *Id.*

⁴² *Id.* at 728-29.

⁴³ *Id.* at 729.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 730.

⁴⁸ *Id.* at 729.

⁴⁹ *Id.* at 730.

⁵⁰ *Id.* at 737.

⁵¹ *Id.*

⁵² *Id.* at 737-38.

Myzels obtain it.”⁵³ On appeal, the court stated the liability of the Levines is governed neither by principles of agency nor conspiracy.⁵⁴

The appellants argued “that the instruction omits as a prerequisite to liability that under the ‘plan’ the Levines also must know that the method to be used by the Myzels would be unlawful, relying upon common law conspiracy cases.”⁵⁵ The court rejected this argument, stating as follows:

However, where the evidence shows the ‘controlling person’ is the actual intended beneficiary of the stock purchase, ‘control’ under the Act does not require knowledge of the specific wrongdoing any more than a principal must know in advance of his agent's fraud. All that is required is that the controlling person ‘directly or indirectly’ induces the purchase. Under such circumstances, if the direct purchaser fails to disclose material information in violation of Rule 10b-5, the ‘controlling person’ cannot excuse himself, even under the ‘good faith’ clause of Section 20(a). *To hold otherwise would vitiate the plain meaning of Section 20(b), that one cannot do indirectly through another what he cannot do himself.* Therefore, even assuming arguendo, that there was failure to properly instruct under a civil or criminal conspiracy theory, the language of Section 20 obviates any possible prejudicial effect. Furthermore, the court not only required the Levines to know of Myzels' activities, but required ‘approval’ of them, before they were responsible. Such requirements are neither explicit not implicit in the Act. We think this qualified instruction adequately protected the rights of all appellants.⁵⁶

While *Myzel* is mildly instructive in its discussion of controlling persons, it subsequently received negative treatment by the Eighth Circuit and other jurisdictions, so its relevance to Section 20(b) claims is limited.

2. *Nelson v. Nat'l Republic Bank of Chicago*

This district court case was filed by investors who alleged that the defendants, through a course of willful nondisclosure, caused bonds to be placed

⁵³ *Id.* at 738.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* at 738-39. (emphasis added).

in the interstate market for sale to plaintiff.⁵⁷ Also, “[p]laintiffs allegedly would not have purchased the bonds if various defendants had disclosed information that they had a legal obligation to reveal.”⁵⁸ Plaintiff further alleged “that the defendants had an obligation to reveal this information, and that their failure to do so ultimately caused damage to plaintiff when the bond issuers went bankrupt.”⁵⁹ One count was directed at the bank, an insurer and multiple individual defendants as controlling persons under Sections 15 and 20 of the 1934 Act.⁶⁰ This specific allegation was that the bank controlled the activities of an individual, the insurer controlled the bank, multiple individuals controlled the bank, and the directors of a broker-dealer controlled the activities of the broker-dealer.⁶¹

In rejecting the bank’s motion to dismiss this particular claim for relief, the court emphasized twice that Section 20(b) provides for broad liability and it held that the directors of the broker-dealer may be considered controlling persons for violations of the Exchange Act.⁶² As a result, the court denied the motion to dismiss and the Section 20(b) claim was allowed to proceed.⁶³

This case remains good law and it is noteworthy because it has been cited positively for the proposition that directors and executive officers normally would constitute a controlling group.⁶⁴

3. *Hollinger v. Titan Capital Corp.*

“Emil Wilkowski, a dishonest securities salesman, embezzled money entrusted to him by four clients.”⁶⁵ Wilkowski also failed to inform the National Association of Securities Dealers (“NASD”) of a prior forgery conviction in his application for registration with the NASD.⁶⁶ Regardless, Wilkowski was

⁵⁷ Nelson v. Nat’l Republic Bank of Chicago, No. 80 C 6401, 1984 WL 2424, at *1 (N.D. Ill. 1984).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* at *7.

⁶¹ *Id.*

⁶² *Id.* at *8.

⁶³ *Id.*

⁶⁴ See ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS, § 11:4 (2015).

⁶⁵ Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1566 (9th Cir. 1990).

⁶⁶ *Id.*

convicted of criminal securities fraud and grand theft.⁶⁷ Thereafter, the victimized investors sought to recover their losses from the brokerage firm, Titan, and a financial counseling firm with which Wilkowski was associated.⁶⁸ One of the investors' claims was that Titan was primarily liable under § 10(b) of the 1934 Act and Rule 10b-5 for failing to disclose to investors Wilkowski's prior forgery conviction.⁶⁹ Additionally, the court considered whether Titan, a broker-dealer, was a "controlling person" with respect to its registered representatives within the meaning of Section 20(a) of the 1934 Act.⁷⁰

The district court determined Titan was not a "controlling person" within Section 20(a) for two reasons: (1) "Titan had no "power or influence" over Wilkowski because he was an independent contractor and Titan did not exercise any control over Wilkowski's defalcation of funds; [Titan] did not benefit from the defalcation of funds; and did not authorize Wilkowski to receive personal checks"; and, (2) "because Titan and Wilkowski had contractually agreed Wilkowski would be an independent contractor, Titan had no duty to supervise unauthorized and unknown transactions and therefore could not have been a 'culpable participant' in Wilkowski's misdeeds."⁷¹ However, the Ninth Circuit reversed on this issue, accepting the SEC's arguments, supplied in its amicus curiae brief, that a broker-dealer is a controlling person under Section 20(a) with respect to its registered representatives.⁷² The SEC also contended "that the representative/broker-dealer relationship is necessarily one of controlled and controlling person because the broker-dealer is required to supervise its representatives."⁷³ Moreover, the SEC asserted "the broker-dealer exercises control over its registered representatives because the representatives need the broker-dealer to gain access to the securities markets."⁷⁴ Adopting the SEC's position, the Ninth Circuit rejected Titan's "argument that broker-dealers can avoid a duty to supervise simply by entering into a contract that purports to make

⁶⁷ *Id.* at 1567.

⁶⁸ *Id.* at 1566.

⁶⁹ *Id.* at 1572.

⁷⁰ *Id.*

⁷¹ *Id.* at 1572-73.

⁷² *Id.* at 1574.

⁷³ *Id.* at 1573.

⁷⁴ *Id.*

the representative, who is not himself registered under the Act as a broker-dealer, an ‘independent contractor.’”⁷⁵

In Section IV of the majority opinion, the investors “also claim[ed] on appeal that the district court erred in granting summary judgment to Titan on [their] claim that Titan was secondarily liable for Wilkowsi’s Section 10(b) violation under the common law theory of *respondeat superior*.”⁷⁶ The Ninth Circuit reversed and remanded the matter, permitting the investors to move forward with their theories of liability based on both Section 20(a) and *respondeat superior*.⁷⁷ The court stated that Section 20(a) was intended to “to prevent evasion” of the law “by organizing dummies who will undertake the actual things forbidden.”⁷⁸ The court asserted that Section 20(a) “was intended to impose liability on controlling persons, such as controlling shareholders and corporate officers, who would not be liable under respondeat superior because they were not the actual employers.”⁷⁹ Thus, [the court reasoned that Congress, by] enacting Section 20(a), ... expanded upon the common law and ... created a defense (the good faith defense) that would be available only to those who, under common law principles of respondeat superior, would have faced no liability at all.”⁸⁰ As part of this, the court believed that Congress expanded the common law by enacting Section 20(a) to permit a comprehensive statutory scheme to protect the public.⁸¹ It also considered the following possibilities that may flow from controlling persons:

When both remedies are available, then the agent who personally committed the wrong is primarily liable (based on proof of his actions or omissions, and on scienter when required); the principal who acts through the agent (assuming the agent is acting within the scope of his agency) is secondarily liable; and other persons who are not subject to respondeat superior but who nevertheless control the wrongdoer can be held liable under § 20(a). Because the liability of persons under § 20(a) represents an extension of liability, beyond that imposed by the common law, such persons

⁷⁵ *Id.* at 1574.

⁷⁶ *Id.* at 1576.

⁷⁷ *Id.* at 1578.

⁷⁸ *Id.* at 1577.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

are afforded statutory defenses not available in the principal-agent context. Controlling persons may thus avoid liability under § 20(a) by demonstrating that they acted in “good faith” within the meaning of that section.⁸²

Notably, the dissent, written by Circuit Judge Hall, disagreed with the majority’s opinion in Section IV.⁸³ Circuit Judge Hall took a different view of the legislative history of Section 20(a) and believed that preventing “dummy” corporations from escaping liability was only one purpose and that the primary purpose was to limit liability to those whose conduct is in some sense culpable.⁸⁴ Instead, she argued that Section 20(a) was modeled on Section 15 of the Securities Act of 1933, which rejected the notion of “insurer” liability.⁸⁵ The basis for her reasoning was from *Christoffel v. E.F. Hutton & Co.*,⁸⁶:

Legislative history reveals that the Senate and the House had advocated different versions of the standard that should govern controlling persons. The House proposed that the standard should be a “fiduciary standard,” which would require a duty of due care. (H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); H.R. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).) On the other hand, the Senate proposed an “insurer’s liability” (S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933), the Fletcher Report). Congress enacted the House version, rejecting the insurer concept.⁸⁷

Additionally, she characterized the majority’s reading of the legislative history as “illogical” because Congress would not have enacted Sections 20(a) and (b) to catch “dummy” organizations and give them a good faith defense but deny this for ordinary controlling persons such as employers.⁸⁸ Accordingly, she contended that holding an employer liable for securities fraud committed by an employee without proof of fault would violate the express language of the Act.⁸⁹

⁸² *Id.* at 1577-78.

⁸³ *Id.* at 1579.

⁸⁴ *Id.* at 1579-80.

⁸⁵ *Id.* at 1580.

⁸⁶ *Id.* at 1577-78.

⁸⁷ *Titan Capital Corp.*, 914 F.2d at 1580 (citing *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir.1978)).

⁸⁸ *Id.* at 1581.

⁸⁹ *Id.*

This is because Section 20(a) extends the good faith defense to employers and there is no justification for expanding employer liability under respondeat superior.⁹⁰ Thus, she objected to holding broker-dealers secondarily liable under the common law doctrine of respondeat superior because it would render Section 20(a) superfluous, “for [employers] would be responsible despite their having fulfilled a stringent good faith test based on their having maintained and enforced reasonable and proper supervision and internal controls.”⁹¹

4. *Janus Capital Group, Inc. v. First Derivative Traders*

a. Factual Background

In this case, “First Derivative Traders (First Derivative) represent[ed] shareholders who owned mutual funds.”⁹² Janus Capital Group (JCG) was the parent company and creator of Janus Investment Fund.⁹³ JCG’s subsidiary, Janus Capital Management (JCM) was the fund’s administrator and investment adviser.⁹⁴ The Janus Investment Fund (JIF) was a separate legal entity owned entirely by mutual fund investors and was not included as a party to this lawsuit.⁹⁵ During the relevant period of time, “all of [JIF’s] officers were also officers of JCM [and] one member of JCF’s board of trustees was also associated with JCM.”⁹⁶

JIF issued a prospectus in February 2002 stating the funds were not suitable for market timing, but by September 2003 it came to light that JCG had entered into secret arrangements to permit market timing in several of JCM’s funds.⁹⁷ Thereafter, First Derivative filed a complaint for violations of Rule 10b-5 and §10b of the Securities and Exchange Act of 1934.⁹⁸ Justice Breyer characterized this as a “typical” Rule 10b-5 “fraud on the market” claim with First Derivative alleging JCM made statements creating the misleading impression it would implement measures to curb market timing.⁹⁹ Additionally, First

⁹⁰ *Id.*

⁹¹ *Id.* at 1582. .

⁹² *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2297 (2011).

⁹³ *Id.* at 2297-98.

⁹⁴ *Id.*

⁹⁵ *Id.* at 2298.

⁹⁶ *Id.* at 2299.

⁹⁷ *Id.* at 2300.

⁹⁸ *Id.*

⁹⁹ *Id.* at 2306.

Derivative alleged JCG was liable for JCM's acts as a "controlling person" under Section 20(a).¹⁰⁰

b. The Majority's Opinion

Although the Fourth Circuit determined that First Derivative sufficiently alleged that JCG and JCM made the misleading statements because they participated in the writing and dissemination of the prospectuses, the Supreme Court reversed.¹⁰¹ Writing for the 5-4 majority, Justice Thomas concluded that the "maker" of a statement is the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."¹⁰² Specifically, this meant that JCM could not be liable because it did not "make" any of the statements in the JIF prospectuses.¹⁰³ This decision was reached in spite of the Court acknowledging that First Derivative "persuasively argue that investment advisers exercise significant influence over their client funds" because JCM and JCF were legally separate entities and corporate formalities were observed here.¹⁰⁴ Moreover, reapportioning liability is "properly the responsibility of Congress and not the courts."¹⁰⁵

Concerning the Section 20(a) claim for control person liability, the Court agreed that First Derivative's theory "resembles the liability imposed by Congress for control."¹⁰⁶ However, it declined to adopt the theory because it would "[r]ead into Rule 10b-5 a theory of liability similar to—but broader in application than, see post, at 2310 — what Congress has already created expressly elsewhere."¹⁰⁷ Also, even if JCM was significantly involved in drafting the prospectus, it did not make any of the statements because JIF had "ultimate control."¹⁰⁸

¹⁰⁰ *Id.* at 2301.

¹⁰¹ *Id.* at 2299.

¹⁰² *Id.* at 2302.

¹⁰³ *Id.* at 2305.

¹⁰⁴ *Id.* at 2304.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* In a footnote, Justice Thomas also commented: "We do not address whether Congress created liability for entities that act through innocent intermediaries in 15 U.S.C.A. § 78t(b)." *Id.* at 2304 n. 10.

¹⁰⁸ *Id.* at 2305.

c. Justice Breyer's Dissent

In dissent, Justice Breyer argued that many different individuals and company representatives “might ‘make’” statements in a prospectus -- even if the board of directors has ultimate content-related responsibility.”¹⁰⁹ Also, he framed the main issue as whether JCM is primarily liable for violating the Act, not whether it simply helped others violate the Act.¹¹⁰ Additionally, he contended there is no basis for the majority’s view that its rule is necessary to avoid a “theory of liability similar to – but broader in application than” Section 20(a)’s control person liability.¹¹¹ This is because the Court previously held that the possibility of an express remedy under the securities laws does not preclude a claim under § 10(b).¹¹² Thus, in reviewing the facts, Justice Breyer determined that JCM “made” the fraudulent statements about market timing in the prospectuses and concluded JCM was liable, stating: “as long as some managers, sometimes, can be held to have ‘ma[d]e’ a materially false statement, [JCM] can be held to have done so on the facts alleged here.”¹¹³

Moreover, Justice Breyer stated his concern that the majority’s rule would make it unlikely the SEC could pursue primary violators who “make” false statements or pursue aiders and abettors.¹¹⁴ This is because managers would not be liable as principals because they did not “make” the statement and there would be no other primary violator that might have tried to “aid” or “abet.”¹¹⁵ Therefore, this is problematic because it may well create a loophole which Congress did not intend in enacting the securities laws.¹¹⁶ In this regard, addressing the majority’s footnote concerning Section 20(b), Justice Breyer stated, as follows:

If the majority believes, as its footnote hints, that § 20(b) could provide a basis for liability in this case, ante, at 2304, n. 10, then it should remand the case for possible amendment of the complaint. “There is a dearth of authority construing Section 20(b),” which

¹⁰⁹ *Id.* at 2306.

¹¹⁰ *Id.* at 2308.

¹¹¹ *Id.* at 2310.

¹¹² *Id.*

¹¹³ *Id.* at 2312.

¹¹⁴ *Id.* at 2310.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 2311.

has been thought largely ‘superfluous in 10b–5 cases.’ 5B A. Jacobs, *Disclosure and Remedies Under the Securities Law* § 11–8, p. 11–72 (2011). Hence respondent, who reasonably thought that it referred to the proper securities law provision, is faultless for failing to mention § 20(b) as well.¹¹⁷

Remarkably, Justice Breyer also addressed the issue of whether JCM could have “ma[d]e” the false statements in the prospectuses at issue and concluded affirmatively that it did.¹¹⁸ He opined that the specific relationships alleged among JCM, the JIF, and the prospectus statements warrant the conclusion that JCM did “make” those statements.¹¹⁹ However, because Justice Breyer reached this particular conclusion, he did not evaluate the potential success or failure of a Section 20(b) claim.

C. Securities and Exchange Commission Actions Involving Section 20(b) After 1934

*1. Sec. Exch. Comm’n v. Coffey*¹²⁰

“This was an action to enjoin corporate officials personally for alleged corporate violations of federal securities laws.”¹²¹ In this case, a corporation, King Resources, sold two-year corporate notes to a state treasurer.¹²² The SEC asserted that King was a controlling person within section 20(a) of the 1934 Act and that it may be inferred from the District Court’s holding that he failed to establish a ‘good faith’ defense, since the District Court ruled against King.¹²³

The Sixth Circuit rejected the SEC’s position and held that section 20(a) of the 1934 Act may not be relied upon by the SEC in an injunctive enforcement action.¹²⁴ Instead, the court stated that Section 20(b) of the 1934 Act provides for the unlawful actions of controlling persons, and the SEC may only seek injunctions against unlawful actions.¹²⁵ Section 20(a) of the 1934 Act makes a

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Sec. Exch. Comm’n v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).

¹²¹ *Id.*

¹²² *Id.* at 1308.

¹²³ *Id.* at 1318.

¹²⁴ *Id.*

¹²⁵ This part of the Sixth Circuit’s holding concerning injunctive relief as the sole means to address unlawful action under Section 20(b) has been challenged as being of “questionable” validity. *See*, ARNOLD S. JACOBS, *DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS* § 11:8 (2015).

controlling person liable “to any person to whom such controlled person is liable.”¹²⁶ “As a matter of legislative interpretation, [the court held] that the SEC is not a person under section 20(a), since section 20(a) was meant to specify the liability of controlling persons to private persons suing to vindicate their interests. Section 20(b) sets forth the standard of lawfulness to which a controlling person must conform, on penalty of liability in injunction to the SEC or criminal prosecution.”¹²⁷

“Under section 20(b), [a party must show] knowing use of a controlled person by a controlling person before a controlling person comes within its ambit.¹²⁸ Without such a restriction, every link in a chain of command would be personally criminally and civilly liable for the violations of inferior corporate agents.¹²⁹ This was not the congressional intent in enacting section 20(b).”¹³⁰ Accordingly, the court concluded that King, board chairman of King Resources Co, did not aid-abet misrepresentations and omissions concerning King Resources made by an intermediary “money finder” in selling King Resources securities to the State of Ohio.¹³¹ Also, there was no evidence King knew of the misrepresentations and omissions, nor that he knowingly assisted or intended to aid.¹³²

Because this case is based on unsupported assumptions regarding the legislative history and reaches a number of fatally flawed conclusions, a thorough analysis and criticism of its reasoning appears in Section V, below.

2. *Sec. Exch. Comm’n v. Savoy Industries, Inc.*

The SEC alleged that Zimmerman, or a group of which Zimmerman was a member, controlled Savoy Industries.¹³³ Under this “control” branch of liability, the SEC maintained that Zimmerman was liable vicariously for Savoy promulgating or filing documents, including an “allegedly misleading Form 8-K, Form 10-K, American Stock Exchange listing application, and letter to

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Sec. Exch. Comm’n v. Savoy Indus., Inc.*, 587 F.2d 1149, 1152 (D.C. Cir. 1978).

stockholders.”¹³⁴ In essence, Zimmerman failed to disclose his identity and role in a takeover transaction in Savoy’s filings.¹³⁵

In its analysis, the D.C. Circuit stated as follows: “The history of the interpretation of [S]ection 20 in the courts has hardly been a history of consistency, especially in the context of SEC enforcement actions.”¹³⁶ The court acknowledged the Second Circuit has suggested that section 20(a) is available to the Commission in enforcement proceedings in *Sec. Exch. Comm’n v. Management Dynamics, Inc.*,¹³⁷ where the court stated that “(w)e agree with the Commission that with respect to SEC enforcement actions, Section 20(a) was not intended as the sole measure of employer liability.”¹³⁸

The D.C. Circuit assumed that Section 20(a) was available for the SEC to pursue, but the court remanded the matter for further findings.¹³⁹ The court noted it was troubled by the fact that the district court did not recite its statutory basis for imposing liability on Zimmerman.¹⁴⁰ It also stated there was “no specific finding that Zimmerman used Savoy knowingly.”¹⁴¹ Moreover, the court wanted to see a finding that Zimmerman used Savoy, but the evidence was speculative and did not convince the court to affirm on a Section 20(b) theory.¹⁴² In sum, the court wanted to see more persuasive evidence that Zimmerman controlled Savoy to accomplish the securities violation.¹⁴³

On remand, the District Court found that Zimmerman controlled both the takeover group and Savoy, through its officers and directors, during the period of dissemination of the false and misleading documents at issue in the litigation.¹⁴⁴ Accordingly, the District Court held Zimmerman responsible under Sections 10(b), 13(a), 13(d), 20(a), and 20(b) of the Securities Exchange Act of

¹³⁴ *Id.* at 1161.

¹³⁵ *Id.* at 1169.

¹³⁶ *Id.*

¹³⁷ *Sec. Exch. Comm’n v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).

¹³⁸ 587 F.2d at 1170.

¹³⁹ *Id.* at 1171.

¹⁴⁰ *Id.* at 1169.

¹⁴¹ *Id.* at 1170.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Sec. Exch. Comm’n v. Savoy Indus., Inc.*, 665 F.2d 1310, 1313-14 (D.C. Cir. 1981).

1934 and Rule 10b-5 thereunder.¹⁴⁵ And on appeal after remand, the district court's findings were upheld.¹⁴⁶

3. *Dirks v. Sec. Exch. Comm'n*

In this matter, the Supreme Court devoted one line of the opinion to Section 20(b) claims, as follows:

Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.¹⁴⁷

Stated differently, because Section 20(b) makes illegal violations of the 1934 Act committed “through or by means of any other person,” the Court reasoned that it outlawed trades by tippees that benefit insiders.¹⁴⁸ While *Dirks* has received some negative treatment since it was decided with a number of jurisdictions declining to follow the opinion, in this context it remains good law.

4. *Sec. Exch. Comm'n v. Stringer*¹⁴⁹

In this matter, the SEC contended it had standing to bring an enforcement action against a control person under Section 20(a) of the Exchange Act.¹⁵⁰ The dispute concerned the burden of proof under Section 20(a) as compared to Section 20(b).¹⁵¹ According to the court, Section 20(a) shifts to the alleged controlling person the affirmative obligation to negate his or her role in the conduct underlying the claim by proving that he “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.”¹⁵² In contrast, the court found that Section 20(b) contains no such provision and leaves the burden of proof against a control person squarely on the

¹⁴⁵ *Id.* at 1314.

¹⁴⁶ *Id.* at 1315.

¹⁴⁷ *Dirks v. Sec. Exch. Comm'n*, 463 U.S. 646, 659 (1983).

¹⁴⁸ Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

¹⁴⁹ *Sec. Exch. Comm'n v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011, at *1 (D. Or. 2003).

¹⁵⁰ *Id.* at *3 (D. Or. Sept. 3, 2003)

¹⁵¹ *Id.*

¹⁵² *Id.*

SEC.¹⁵³ The court stated the Ninth Circuit has not addressed this issue and that two of the other circuits disagree.¹⁵⁴ The SEC argued and the Second Circuit previously held that the SEC may bring an enforcement action under Section 20(a).¹⁵⁵ But, *Stringer* and the Sixth Circuit¹⁵⁶ take the opposite view.¹⁵⁷ In this opinion, the District court concluded “the only way to harmonize the two provisions ... is to read § 20(a) as a private claim and § 20(b) as an enforcement claim.”¹⁵⁸

In examining Section 20(b), the court finds it is “specifically geared toward government enforcement actions. Section 20(b) is [titled] ‘unlawful activity through or by means of any other person’ and provides a mechanism for the SEC to enforce violations of the securities laws committed ‘through or by means of’ other persons.”¹⁵⁹ Notably, the court also states that “Sections 20(a) and 20(b) create secondary liability [, the] difference being that Section 20(a) puts the burden on the defendant to prove an affirmative defense to avoid liability.”¹⁶⁰ The opinion also comments on both Sections 20(b) and 20(c) using the term “unlawful” and this is noticeably absent in Section 20(a) which instead uses the term “liable.”¹⁶¹ As a result, the court determined “[t]his difference in

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* See *Sec. Exch. Comm’n v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2nd Cir. 1996), *cert denied*, 522 U.S. 812, 118 S.Ct. 57, 139 L.Ed.2d 21 (1997).

¹⁵⁶ The Sixth Circuit reasoned that because § 20(b) of the Exchange Act “sets forth the standard of lawfulness to which a controlling person must conform, on penalty of liability in injunction to the SEC or criminal prosecution,” § 20(a) was meant only “to specify the liability of controlling persons to private persons suing to vindicate their interests.” *Sec. Exch. Comm’n v. Coffey*, 493 F.2d 1304 (6th Cir.1974). Accordingly, the Sixth Circuit held that the SEC was “not a person under section 20(a)” and that the SEC could not rely on § 20(a) when seeking personal injunctions against corporate officials for a corporation’s alleged violations of the securities laws. *Sec. Exch. Comm’n v. J.W. Barclay & Co., Inc.*, 442 F.3d 834, 842 (3d Cir. 2006). Nevertheless, the Dodd-Frank Act effectively resolved the debate among the circuit courts by explicitly granting the SEC standing to bring Section 20(a) claims. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §929P(c), 124 Stat. 1376, 1864 (2010).

¹⁵⁷ *Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974), *cert denied*, 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed.2d 837 (1975).

¹⁵⁸ *Sec. Exch. Comm’n v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011, at *1, *2 (D. Or. Sept. 3, 2003).

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at *7.

terminology cannot be ignored and lends credence to the interpretation that Section 20(a) does not include an enforcement action by the SEC.”¹⁶²

Here, “the SEC argued Section 20(b) was intended as an ‘aiding and abetting catch-all’ provision to allow the SEC to pursue an enforcement action against officers and directors for violating any provision of the securities laws that does not itself have the ‘direct or indirect’ language.”¹⁶³ However, the court rejected this argument using the reasoning of *Central Bank*,” stating that the “‘directly or indirectly’ language shows that ‘Congress ... intended to reach all persons who engage, even if only indirectly, in proscribed activities connected with securities transactions.’”¹⁶⁴¹⁶⁵ Also, “aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do.”¹⁶⁶ Moreover, “allowing enforcement actions by the SEC under Section 20(a) would render Section 20(b) superfluous.”¹⁶⁷ This is because “[u]nder Section 20(b), the scienter requirement will differ depending on the underlying violation.”¹⁶⁸ “Section 20(a) has no scienter requirement, but instead allows a control person to raise the good faith defense.”¹⁶⁹

Regardless, the court also analyzed two situations the SEC identified where the SEC argued “it would be unable to pursue an enforcement action under Section 20(b), but would be able to do so under Section 20(a).”¹⁷⁰ First is the situation where a director, acting in good faith, orders the corporation to take an action without knowing how the action could be used by the corporation, and the corporation takes that action which violates the securities laws.¹⁷¹ In that situation, the director may have acted in “good faith,” but did not induce the

¹⁶² *Id.*

¹⁶³ *Id.* at *13.

¹⁶⁴ *Id.*

¹⁶⁵ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175-76 (1994).

¹⁶⁶ *Sec. Exch. Comm’n v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011, at *1, *13 (D. Or. Sept. 3, 2003)..

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at *15.

¹⁷¹ *Id.*

violation to occur and, therefore, cannot prove the Section 20(a) defense.¹⁷² The second scenario is where a CEO orders the corporation's finance department to reduce expenses and the sales department to increase revenues, and then imposes unrealistic goals with incentives, resulting in a securities violation by the corporation.¹⁷³ In that situation, even though the CEO may not have induced the corporate act, he did not act in "good faith" and, therefore, cannot prove the Section 20(a) defense.¹⁷⁴ Although these examples on their face would allow enforcement under Section 20(a), they also appear to allow enforcement under Section 20(b) under the theory that the person "indirectly" did some act which violated the securities laws."¹⁷⁵

This last comment was an interesting and unexpected result by the court, which concluded that both sections impose secondary liability on persons who act by and through others.¹⁷⁶ Whether or not this latter point has any merit will be examined later, as there is questionable support for the court's rationale.

5. *Sec. Exch. Comm'n v. J.W. Barclay & Co.*

The SEC initiated administrative proceedings against Barclay, determined there were multiple violations and ordered Barclay to pay a \$25,000 penalty.¹⁷⁷ Thereafter, Barclay ceased operations as a broker-dealer and violated the SEC's net capital requirements.¹⁷⁸ Also, one of Barclay's founders, who also happened to be Barclay's President and a majority shareholder, John Bruno, directed Barclay not to use any of its funds to pay any part of the \$25,000 penalty.¹⁷⁹ As a result, the SEC filed an application against Barclay and Bruno in District Court.¹⁸⁰ Bruno argued that the SEC could not assert control person liability against him under Section 20(a) "and hold him responsible for the civil penalty against Barclay" because Bruno was not a party to the proceedings before the SEC and no order was issued against him.¹⁸¹

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Sec. Exch. Comm'n v. J.W. Barclay & Co.*, 442 F.3d 834, 837-38 (3d Cir. 2006).

¹⁷⁸ *Id.* at 838.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 839.

The District Court granted the SEC's motion for summary judgment, Bruno appealed and the Third Circuit appointed an attorney as amicus curiae to address whether the SEC has standing to bring a control person claim under Section 20(a).¹⁸² Here, the Third Circuit stated that "in order for Bruno to be jointly and severally liable under § 20(a): (1) the SEC has to be a person; (2) to whom the controlled person, Barclay, was liable; (3) as a result of some act or acts constituting a violation or cause of action under any provision of the Exchange Act or any rule or regulation thereunder."¹⁸³ Holding that the SEC is a person within the meaning of Section 20(a) and declining to join in the Sixth Circuit's contrary holding in *Sec. Exch. Comm'n v. Coffey*, the Third Circuit stated that the relevant liability of the controlled person for the purpose of defining the control person's joint and several liability under § 20(a) is the controlled person's obligation to pay some amount to a creditor when that claim for payment arises under the securities laws.¹⁸⁴ And because the facts were uncontested, Barclay was found to be liable under Section 20(a) for the unpaid penalty.¹⁸⁵ Also, Bruno, having controlled Barclay, induced and was a culpable participant in the act constituting the cause of action, and was jointly and severally liable for the penalty.¹⁸⁶ In reaching its conclusion, the Third Circuit stated, as follows:

We further note that our construction of Section 20(a) serves the remedial purposes of the Exchange Act. With a more narrow construction of Section 20(a), the deterrent effects of civil penalties arising under the Exchange Act would be diluted in cases such as this one where a closely-held firm is subject to a penalty, and the persons controlling the firm transfer the firm's assets to themselves, causing the firm to be unable to pay its penalty. Although Section 20(b) may provide an overlapping remedy in some such cases, control persons who induce the transfers of the firm's assets to themselves may not have participated in the underlying violations. In that sense, our cumulative construction of Section 20(b) and Section 20(a) targets different forms of wrongdoing, and thus Section 20(a), given our construction, could reach wrongdoers who might otherwise escape liability under

¹⁸² *Id.*

¹⁸³ *Id.* at 841.

¹⁸⁴ *Id.* at 843.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 845.

Section 20(b). Consequently, our construction of Section 20(a) is also supported by the remedial purposes of the Exchange Act.¹⁸⁷

In a footnote, the Third Circuit also stated that it agreed with the Sixth Circuit in *Coffey* that Section 20(b), not Section 20(a), defines the general “standard of lawfulness to which a controlling person must conform.”¹⁸⁸ It also accepted the reasoning from *Sec. Exch. Comm’n v. Stringer* that while a control person could be held liable in an SEC enforcement action under Section 20(b) for certain violations committed by a controlled person, in such a case the SEC itself would not be an “injured party,” and the defendants in such an enforcement action would not be “liable to the SEC the way that [they] would be liable to a private plaintiff.”¹⁸⁹

6. *Sec. Exch. Comm’n v. Daifotis*,

In this matter, the court disagreed with the *Stringer* decision, stating as follows: “The SEC is a government agency tasked with enforcing federal securities laws. It is not an injured party.”¹⁹⁰ Relying on *Security Exchange Commission v. Zanford*,¹⁹¹ the court explained that federal securities laws should be construed “not technically and restrictively, but flexibly to effectuate [their] remedial purposes.”¹⁹² It also held that the SEC, the very agency charged with enforcing federal securities laws, can hold control persons liable and that the opposite result would contradict the purpose of securities laws.¹⁹³

As a result of this decision, a split exists as to whether the SEC may pursue claims under Section 20(a). Whether it will be resolved favorably for FINRA and the SEC remains to be seen, but the natural result should be that the government enforcement agencies should be able to pursue these claims. This is because there was no such limit imposed in the language of Section 20(a) or that arose during the debates on the legislative history.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 843 (citing *Sec. Exch. Comm’n v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974)).

¹⁸⁹ *Barclay*, 442 F.3d at 843 (citing *Sec. Exch. Comm’n v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011 at *1, *6 (D. Or. Sept. 3, 2003)).

¹⁹⁰ *Sec. Exch. Comm’n v. Daifotis*, No. C 11-00137 WHA, 2011 WL 4714250 at *1, *5 (N.D. Cal. Oct. 7, 2011).

¹⁹¹ 535 U.S. 813, 815 (2002).

¹⁹² *Daifotis*, 2011 WL 4714250, at *5.

¹⁹³ *Id.*

D. SEC Administrative Decisions

In the 1930s, after the passage of the '34 Act, the SEC pursued multiple Section 20(b) claims in conjunction with Section 9 violations. During this period, the SEC was keen on pursuing brokers and other entities who were using “matched orders” to buy and sell stock to manipulate the price. While many examples of the SEC’s cases from this period exist and are easily located, the overwhelming majority of them concerned setting matters for hearing and did not result in a meaningful, substantive decision, except for the following matter.

1. In the Matter of Junius A. Richards

In this case, the SEC alleged that Richards, a broker, had reason to believe that an investment banking firm, Robert Benson & Co., Ltd. (Benson), an English investment banking firm, and its subsidiary, British Financial Union, Ltd., were entering orders for the purchase and sale of the common stock of Simplicity Pattern Company, Inc.¹⁹⁴ The SEC’s order stated that Richards also knew that the banking entities were effecting transactions to create actual or apparent active trading in the stock to raise its price.¹⁹⁵ As a punishment, the SEC suspended Richards’ membership on multiple exchanges based on his conduct in violation of Section 19(a)(3).¹⁹⁶ However, the SEC also determined that Benson violated Section 9(a)(1)(B), 9(a)(1)(C), and 9(a)(2) of the '34 Act for matching orders.¹⁹⁷ Furthermore, the SEC’s order concluded that because the transactions were executed through brokers, the banks were also violating Section 20(b) of the Act, “which [made] it unlawful for a person to do by means of any other person any act or thing which it would be unlawful for such person to do directly.”¹⁹⁸ Based on this language, it suggests that the SEC would have pursued the banks for a Section 20(b) violation as “controlling persons” over Richards. However, the record does not reflect whether the SEC ever pursued these claims, which is unsurprising given the potential difficulty for enforcing violations against foreign entities in 1939.¹⁹⁹

¹⁹⁴ In the Matter of Junius A. Richards, Exchange Act Release No. 708, 4 SEC Docket 742, No. 4-15, 1939 WL 39102 at *1 (Mar. 24, 1939).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at *4.

¹⁹⁷ *Id.* at *2.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at *1-3.

2. *Additional Section 20(b) Claims*

In 1986, the SEC issued a litigation release on a case involving insider trading with alleged violations of Section 20(b) and Rule 10b-5.²⁰⁰ Although the matter resulted in a settlement with some of the defendants, all of the relief concerned the insider trading violation, not the Section 20(b) claim.

While the SEC has filed additional complaints alleging Section 20(b) violations, none of them have been litigated to conclusion since 1986.

E. FINRA Decision Affecting a Section 20(b) Claim

1. *In the Matter of Department of Market Regulation v. Gregory Richard Imbruce*²⁰¹

In this matter, Gregory Imbruce was a portfolio manager who supervised an assistant trader, Peter Berkowitz, for the Madoff Securities' energy portfolio.²⁰² In these roles, Berkowitz took instructions from Imbruce on trading.²⁰³ On November 14, 2007, Imbruce was heading out of town and called Berkowitz.²⁰⁴ According to Imbruce, he instructed Berkowitz to short \$500,000 in value of "any" energy stock to reduce the portfolio's net long position.²⁰⁵ Berkowitz disputed this, testifying that Imbruce instructed him to short sell 10,000 shares of a specific stock, ATP Oil & Gas Corporation (ATPG). Regardless, Berkowitz did in fact sell short 10,000 shares of ATPG that day between \$52.00 and \$53.30 per share.²⁰⁶ That same day, ATPG filed a prospectus with the SEC and a supplement stating that "ATPG intended to initiate a secondary public offering of [five] million shares of common stock at a price of \$47.00 per share."²⁰⁷ After the market closed, Imbruce submitted an indication of interest on behalf of Madoff

²⁰⁰ Sec. Exch. Comm'n v. Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Santa Fe Int'l Corp., Faisal Al Massoud Al Fuhaid, and Luay Tewfik Al Swaidi, 81 CIV. 6553 (WCC) (S.D.N.Y.), Exchange Act Release No. 11012, 35 S.E.C. Docket 183, 1986 WL 70986 at *1 (Feb. 26 1986).

²⁰¹ *In the Matter of Department of Market Regulation v. Gregory Richard Imbruce*, 2012 WL 759812 (N.A.S.D.R. Mar. 7, 2012) (Note: This may be cited alternatively as *In the Matter of Department of Market Regulation v. Gregory Richard Imbruce*, Complaint No. 2008012137601 (2012)).

²⁰² *Imbruce*, 2012 WL 759812, at *1-2.

²⁰³ *Id.* at *2.

²⁰⁴ *Id.*

²⁰⁵ *Id.* at *3.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

Securities to purchase 10,000 shares of ATPG in the secondary public offering.²⁰⁸ The next morning, Imbruce accepted the allocation and Berkowitz was notified of the purchase, acknowledging the transaction and entering it into Madoff Securities' internal system.²⁰⁹ As a result of Imbruce's purchase of ATPG on November 15, 2007, coupled with the short sales on November 14, 2007, Madoff Securities realized a profit of \$58,721.26.²¹⁰

The spike in short sales of ATPG's stock was observed by market surveillance, and a complaint was filed against Imbruce alleging that "[he] violated Exchange Act Rule 105 and NASD Rule 2110 because he purchased shares of ATPG in a secondary public offering ... after he sold the company's stock short during the restricted period."²¹¹ The Hearing Panel found that Imbruce violated Exchange Act Rule 105 and NASD Rule 2110, as alleged in the complaint.²¹² It accepted that Berkowitz's testimony as credible, that Imbruce's testimony was not credible, and that Imbruce had instructed Berkowitz to short sell 10,000 shares of ATPG.²¹³ On appeal, Imbruce offered a variety of arguments, but FINRA affirmed that Berkowitz's short sales of ATPG were attributable to Imbruce for purposes of Exchange Act Rule 105.²¹⁴

Imbruce argued that Exchange Act Rule 105 required that the *same person* effect the short sale and purchase of the subject securities and that he did not violate Exchange Act Rule 105 because he did not short sell ATPG.²¹⁵ FINRA rejected this argument, stating:

Imbruce misunderstands the Exchange Act's broad, remedial approach to securities regulation. The Exchange Act, by its own terms, prohibits individuals from engaging in unlawful activities by means of other persons. See 15 U.S.C. § 78t(b) (2011) ("It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the

²⁰⁸ *Id.* at *4.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.* at *5.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.* at *7.

²¹⁵ *Id.*

provisions of this title or any rule or regulation thereunder through or by means of any other person.”²¹⁶

Consequently, FINRA determined that Imbruce was responsible for the subject short sales, despite the fact that Berkowitz executed the actual trades.²¹⁷ This finding, coupled with the finding that Imbruce purchased ATPG in the company’s secondary public offering from a participating underwriter, was sufficient to establish Imbruce’s violation of Exchange Act Rule 105.²¹⁸

One interesting aspect of this case is that FINRA did not actually charge Imbruce with a Section 20(b) violation, but instead raised the issue *sua sponte*. Why FINRA chose not to pursue a Section 20(b) against Berkowitz and Imbruce is unclear, especially because no scienter is required to prove a violation of Exchange Act Rule 105, “...a prophylactic, [that] providing a bright line demarcation of proscribed conduct, and applies irrespective of a short seller’s intent.”²¹⁹ Consequently, it would have been easy for FINRA to prove that Berkowitz made the short sale as a “controlled person” and that Imbruce was the “controlling person.” It is possible that Berkowitz’s employment situation provides a reasonable explanation – his employment with Madoff Securities was terminated on March 11, 2008 and FINRA admitted it no longer had jurisdiction over him as of March 11, 2010.²²⁰ Thus, because Berkowitz was apparently no longer working in the industry as a registered representative, there was little to be gained in pursuing him from a deterrence standpoint, compared to Imbruce. Alternatively, it is likely that FINRA was seeking Berkowitz’s testimony in a cooperative capacity against Imbruce, which would be considerably more difficult if he was charged as a controlled person. Also, the complaint against Imbruce was not filed until February 25, 2010, and FINRA’s jurisdiction over Berkowitz expired two weeks later. The opinion also stated that while Berkowitz appeared for an interview, he later declined to testify voluntarily at Imbruce’s hearing. Consequently, it may have been challenging to locate him and easier to pursue Imbruce. Nevertheless, with the decision having been published on March 7, 2012, it shows that Section 20(b) claims are alive and well.

²¹⁶ *Id.* at *7, n.27.

²¹⁷ *Id.* at 7.

²¹⁸ *Id.*

²¹⁹ *Id.* at *6.

²²⁰ Pursuant to FINRA’s By-Laws, Art. V, Sec. 4, persons who are no longer registered with a FINRA firm remains subject to FINRA’s jurisdiction for two years after the termination of their association with a firm. *See id.* at *5, n.21.

2. *Additional Guidance from FINRA on Section 20(b)*

As a prime example of how rarely claims arise under Section 20(b), the *Imbruce* decision is the only one to date reported by FINRA. Additionally, the only other reference to Section 20(b) appears in a 1988 release in Notice 88-62, Rule 10B-21, which prohibits shorting into secondary offerings.²²¹ The Rule prohibits purchases of offered securities to cover short sales made during the specified period and it proscribes covering purchases made directly from an underwriter, broker, or dealer participating in the offering.²²² In particular, the Release states:

Moreover, such covering purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of Section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder. Thus, the “prearrangement” of the sort that the NASD believes may have been present in the cases it investigated would be prohibited by Rule 10b-21(I) through the operation of Section 20(b).²²³

In a footnote, the Release further states: “Although Section 20 is entitled “Liabilities of Controlling Persons,” paragraph (b) is not limited to situations involving persons in control relationships.”²²⁴ While this footnote is intriguing, without more detail it is challenging to determine what FINRA was contemplating in this regard.

IV. SUMMARY OF VIEWS PROVIDED BY COMMENTATORS

Since 1934, many commentators have set forth their views on Section 20(b) and its potential use. The following sets forth a summary of their opinions concerning the legislative history, its application and the meaning behind Section 20(b). For ease of reference, the comments are provided as they were originally published, in chronological order.

²²¹ NASD Notice 88-62, *Rule 10B-21 Prohibiting Shorting Into Secondaries*, 1988 WL 862208 (1988).

²²² *Id.* at *8.

²²³ *Id.*

²²⁴ *Id.* at *8, n.22.

A. William B. Herlands – 1934

An early analysis of the Securities and Exchange Act of 1934 examines “the statutory provisions from the point of view of criminal liability, ... classify[ing] them into one of three general types”:

- (1) Absolute and unqualified prohibitions; i.e., statutory provisions prohibiting the doing of certain acts under all circumstances;
- (2) Conditional and qualified prohibitions; i.e., statutory provisions referring in general terms to the prohibition of certain acts, the extent and details of such prohibitions to be determined by the rules and regulations of the Commission and the Federal Reserve Board; and,
- (3) Affirmative requirements; i.e., statutory provisions requiring the doing of certain acts.²²⁵

Citing to testimony from the Senate Hearings, Mr. Herlands asserts “[t]he provisions may be classified functionally into four fields of regulation: (a) The control of credit that flows into the stock market; (b) The protection of investors from evils that are possible under existing stock market machinery; (c) The protection of investors from ignorance and exploitation by large inside operators; and, (d) The regulation of over-the-counter markets in unlisted securities with resulting protection to securities listed on registered exchanges.”²²⁶ Under this framework, although Mr. Herlands did not specify, a reasonable interpretation is that subsections (b) and (c) would be the most likely categories for Section 20(b) to be utilized to protect investors.

Moreover, Mr. Herlands classifies violations of Section 20(b) in the category of violations where an absolute and unqualified prohibition exists.²²⁷ He also characterizes Section 20(b) as the “principal-accessory rule.”²²⁸

²²⁵ William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 No. 2 VA. L. REV., 139, 150-51 (1934).

²²⁶ *Id.* at 150, n.31(citing Testimony of T. G. Corcoran, S. Hearings, 6465-66; Testimony of L. J. Stern, S. Hearings, 6973-74; Testimony of T. G. Gay, S. Hearings, 6587).

²²⁷ *Id.* at 150.

²²⁸ *Id.* at 168.

B. Bernard Wexler²²⁹ –1975

While the Securities Act was wending its way through Congress, the Senate Committee on Banking and Currency was looking into malpractices in the trading markets.²³⁰

That investigation (commonly called the “Pecora Hearings”) uncovered a wealth of material about manipulation, insider trading, breaches of fiduciary duty by the controlling persons of corporations and other strategically situated people who profited handsomely out of the financial distress of the companies that they dominated. It showed how these persons sold the stocks of their own companies short, concealed material information, and engaged in other malpractices.²³¹

Mr. Wexler also commented as follows:

Complying with that direction, the Commission made an exhaustive study of the ... investment company industry. Its report, known as the “Investment Trust Study,” found that to an alarming extent investment companies had been operated in the interests of their managers and to the detriment of investors. A high incidence of recklessness and improvidence was also noted. Insiders often viewed investment companies as sources of capital for business ventures of their own and as captive markets for unsalable securities that they, the insiders, wished to convert into cash. *Controlling persons frequently took unfair advantage of the companies in other ways, often using broad exculpatory clauses to insulate them from liability for their wrongdoing.* Outright larceny and embezzlement were not uncommon. Managers were able to buy investment company shares for less than net asset value, thus enriching themselves at the shareholders’ expense.²³²

²²⁹ Bernard Wexler, Director of the Office of Opinions and Review, wrote a history of the SEC in its first forty years, which was published in 2003; see, Karl Smeltzer, *Memories From Early Days of the Securities and Exchange Commission* (2004), http://www.sechistorical.org/collection/papers/2000/2004_0601_Smeltzer_Memories.pdf.

²³⁰ Bernard Wexler, *History of the Securities and Exchange Commission*, 5 (Aug. 3, 1975), http://www.sechistorical.org/collection/papers/1970/1975_0101_Wexler_History_SEC.pdf.

²³¹ *Id.* at 5.

²³² *Id.* (emphasis added).

Taken in context with the Pecora hearings, Mr. Wexler's statement about controlling persons appears to be entirely consistent with the views espoused by Thomas G. Corcoran and Ferdinand Pecora.²³³

C. Unknown Author – 1978

In this article, the author argues that “controlling person liability should be viewed as a subset of the general liability in section 20(b) for those who violate the law through others.”²³⁴ The author states: “Under this view, the demonstration of a control relationship would establish a prima facie violation of section 20(b) through the use of intermediaries, and would shift the focus of analysis to the controlling person sections, where the burden is upon the defendant to establish the applicability of exculpatory language.”²³⁵ According to the author, “a finding of controlling person status has a ‘dramatic’ effect upon a defendant in a securities action because he then has the burden of establishing a defense.”²³⁶ Thus, “courts should carefully scrutinize allegations of control and remove the controlling person sections from the context of agency.”²³⁷ The author adds: “By viewing controlling person liability as a subset of the general liability of those who accomplish violations through others, courts may gain a perspective on the provisions that will help prevent hasty findings of controlling person status and liability.”²³⁸ Also, “[i]f ... the conceptual basis for imposing liability is to punish those who violate through others rather than to reinforce a pre-existing duty to supervise, much confusion in the status phase of controlling person analysis can be eliminated and better decisions produced.”²³⁹

While the author acknowledges that Section 20(b) has not been used as a vehicle to serve the rule of *respondeat superior* and has apparently been ignored, the challenge with this particular commentary is that the author mainly discusses Section 20(a) violations because of the absence of any decisions involving Section 20(b) claims.²⁴⁰ Because there are differences in the provisions, this makes it

²³³ FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS (1939).

²³⁴ Note, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. PA. L. REV. 1345, 1346 (1978).

²³⁵ *Id.* at 1366.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.* at 1346.

²³⁹ *Id.* at 1346.

²⁴⁰ *Id.* at 1351.

difficult to lump them together in a discussion; for example, Section 20(a) makes control persons “liable” instead of the Section 20(b) “unlawful” language and Section 20(a) provides a good faith defense, where this is not available for Section 20(b).²⁴¹

D. William J. Fitzpatrick and Ronald T. Carman – 1983

Fitzpatrick and Carman state that the majority view permits plaintiffs to predicate liability on a *respondeat superior* theory in actions against broker-dealers and accounting firms alleging violations of section 10(b) and rule 10b-5 and that Section 20(a) does not provide the exclusive means for holding a controlling party liable for violations of the federal securities laws by its agents.²⁴² In contrast, the authors contend that the minority view holds that section 20(a) is the exclusive source of liability.²⁴³

In discussing the issue, Fitzpatrick and Carman obtained an amicus brief filed by the SEC and they quote from it selectively.²⁴⁴ In doing so, the authors state that the SEC argued that *respondeat superior* liability is consistent with the statutory good faith defense provided in Exchange Act section 20(a).²⁴⁵ However, in disagreeing with the SEC’s position, they assert that Section 20(a) precludes the application of the common law doctrine of *respondeat superior*.²⁴⁶ Fitzpatrick and Carman also conclude that the SEC relied “on remarks in the legislative history to

²⁴¹ Section 20(a) provides, as follows:

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.

15 U.S.C. § 78t(a) (2011).

²⁴²William J. Fitzpatrick and Ronald T. Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 3-4 (1983) (emphasis added).

²⁴³ *Id.* at 4.

²⁴⁴ *Id.* at 25, n.28. Although the authors provide a citation for the SEC’s amicus brief at n. 158, the scope of the SEC’s purported argument is unclear and the brief is not presently available on Westlaw or other legal databases. Whether a copy may be available in the archives of the Seventh Circuit is an open question.

²⁴⁵ *Id.* at 24.

²⁴⁶ *Id.* at 1-2.

the effect that the control provisions were designed 'to prevent evasion of the provisions of the [laws] by organizing dummies who will undertake the actual things forbidden by the section.'²⁴⁷ Instead, the authors adopt the following position:

Upon closer examination it appears that these remarks were primarily addressed to section 20(b), not 20(a). With referring to the two sections, the report of the Committee on Interstate Commerce stated that section 20(a) makes "a person who controls a person . . . liable to the same extent as the person controlled unless the controlling person acted in good faith and did not induce the act in question," while section 20(b) "makes it unlawful for any person to do, through any other person, anything that he is forbidden to do himself." It appears then that Exchange Act section 20(b), not 20(a), was specifically aimed at the "dummy" situation.²⁴⁸

Regardless of Section 20(a)'s non-exclusivity, Robert Prentice rebutted Fitzpatrick and Carman's argument in 1997. Prentice argued that this thinking was fatally flawed because all the "dummy" references in the legislative history of the 1933 Act were to section 15.²⁴⁹ Comparing Section 15 to Section 20(a), he asserts that Section 20(a) was drawn nearly verbatim from Section 15 and adopted for the same exact reasons.²⁵⁰ Also, Mr. Prentice's view is that there is no section 20(b) parallel provision in section 15.²⁵¹ Consequently, he contends as follows:

Section 20(b) remains a mysterious provision that, although it has been seldom invoked, seems on its face to contradict any claim that section 20(a) provides the only form of secondary liability. Indeed, section 20(b) can plausibly be read to authorize imposition of *respondeat superior* liability, although no court has so held.²⁵²

²⁴⁷ *Id.* at 26. (quoting Fitzpatrick and Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1 (1983)).

²⁴⁸ *Id.*

²⁴⁹ Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1407 (1997).

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.* at 1407-08.

While Fitzpatrick/Carman may have been correct in part that Section 20(b) was aimed at dummies, as is evident from the legislative history that contains numerous references to dummies, Prentice's interpretation is also important because of his approach concerning the legislative intent. In fact, Prentice makes a compelling argument "that in drafting section 15 and section 20(a), Congress was not even thinking about the liability of employers for their employees."²⁵³ He explained that corporations, accounting firms, and law firms do not "'stand in the shadows' manipulating their agents or act through 'dummies.' Furthermore, they should "answer for the torts of their agents irrespective of the existence of section 20(a)."²⁵⁴ The reason for this is that "in enacting section 20(a), Congress was trying to extend liability beyond the master-servant relationship, where *respondeat superior* liability already universally applied, in order to reach additional, hidden malefactors."²⁵⁵ Thus, "the controlling person liability provisions of the 1933 and 1934 Acts were aimed primarily at situations of control over firms (and others) by behind-the-scenes actors."²⁵⁶ Also, "enactment of the controlling person provisions of the 1933 and 1934 Acts 'was motivated by a fear that traditional theories of secondary liability, such as agency, would not prove adequate, in every case, to extend liability to those who were 'really responsible' for violations of the securities laws."²⁵⁷

While much of Prentice's analysis focuses on Section 20(a), it is important because he makes a strong case for the breadth in scope of control person liability anticipated by the drafters of the '34 Act. Notably, this view is contrary to the opinion of the Sixth Circuit in *SEC v. Coffey*.²⁵⁸

E. William H. Kuehnle – 1989

Kuehnle examines the differences between the control relationship in the statutory provisions and the principal-agent relationship in agency law, concluding that they are not mutually exclusive.²⁵⁹ Instead, he persuasively articulates that Congress merely intended to provide an additional basis of secondary liability

²⁵³ *Id.* at 1408.

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.* at 1410.

²⁵⁷ *See Id.* at 1410, n. 406.

²⁵⁸ *See* Sec. Exch. Comm'n v. Coffey, 493 F.2d 1304 (6th Cir. 1974);

15 U.S.C. § 78t(a) (2011).

²⁵⁹ *See supra*, note 37, at 313..

with its own limiting provisions.²⁶⁰ The language and legislative history of the controlling persons provisions demonstrate that the provisions are not exclusive and provide a helpful foundation for determining the proper application of the controlling person provisions in general.²⁶¹

In particular, referring to the House debates between Representatives Lea and Hollister, Kuehnle posits that the debates clearly indicated that the controlling person provisions were intended to reach beyond situations involving agency liability.²⁶² The focus on control and the absence of any reference to common-law forms of secondary liability in the House report all indicate that the control person provisions were intended to be a special form of liability with its own limiting clause.²⁶³ “[T]he controlling person provisions originated as a device to reach a particular problem that agency or other secondary liability concepts might not reach.”²⁶⁴

As an example, Kuehnle relies on Section 20(a) of the 1934 Act, which has been held to be a basis for liability in enforcement actions.²⁶⁵ However, none of the examples that he provides concern Section 20(b) violations. Nevertheless, this may be partly attributed to the definition of control, which the drafters of the ’34 Act intentionally avoided defining because of the many forms the term could take.²⁶⁶ In this aspect, Kuehnle believed that the House report’s reference to actual control was made to expand coverage beyond legal control rather than constrain the definition of control. Still, “it indicate[d] an intent to require some degree of realistic control, as would be provided by legal or actual control.”²⁶⁷ Additionally, he argues that the use of the term actual control should not be taken necessarily as a limitation.²⁶⁸ In citing *Handy & Harmon*, Congress simply

²⁶⁰ *Id.* at 350.

²⁶¹ *Id.*

²⁶² *Id.* at 352.

²⁶³ H.R. Rep. No. 1838, 73d Cong., 2d Sess. 42 (1934).

²⁶⁴ *See supra*, note 37, at 353.

²⁶⁵ *See* Sec. Exch. Comm’n v. Savoy Indus., 587 F.2d 1149, 1169-70 (D.C. Cir.), cert. denied, 440 U.S. 913 (1978); Sec. Exch. Comm’n v. Savoy Indus., 665 F.2d 1310, 1313 n. 15 (D.C. Cir. 1981); Sec. Exch. Comm’n v. Blinder, Robinson & Co., 542 F.Supp. 468, 475 (D. Colo. 1982).

²⁶⁶ *See supra*, note 37, at 356.

²⁶⁷ *Id.* at 357.

²⁶⁸ *Id.*

contrasted between the broader coverage of this provision and the Supreme Court's narrow interpretation on the Internal Revenue Code.²⁶⁹

On a related note, along the lines of semantics involving control, both the Securities Act of 1933 and the Securities Exchange Act of 1934 use the exact same definition of control:

The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.²⁷⁰

F. P. Gifford Carter – 2001

Carter observes that "Section 20(b) has very little interpretative history that sheds light on what constitutes 'through or by means of.'"²⁷¹ While this may be true, it does not necessarily create an impediment for FINRA or the SEC to pursue Section 20(b) claims, as the *FINRA v. Imbruce* decision demonstrates.²⁷²

Additionally, Carter states that "[m]ost section 20(b) claims are brought by the SEC itself because the courts have ruled that the SEC is unable to seek an injunction under section 20(a)."²⁷³ For support, he relies upon *SEC v. Coffey*.²⁷⁴ However, as we will see in Section V, this is an untenable position when *Coffey* is examined critically and in terms of the trend towards increased penalties for violations of the federal securities laws.²⁷⁵ This is particularly evident in light of the trend to expand penalties, which has continually persisted since the passage of the 1990 Remedies Act, Sarbanes-Oxley in 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Carter also asserts that "[d]espite the paucity of reported opinions regarding Section 20(b) liability, it is clear that at least two elements are required: knowing use of the controlled person by the controlling person and culpable

²⁶⁹ *Id.*

²⁷⁰ See 17 C.F.R. § 230.405 (2014); 17 C.F.R. § 240.12b-2 (2009).

²⁷¹ P. Gifford Carter, *Originator Exposure to Federal Securities Law Liability When Structuring Asset Backed Securities Transactions*, 20 ANN. REV. BANKING L. 271, 293 (2001).

²⁷² *Supra*, Section III, E.

²⁷³ *Supra*, note 279, at 293-94.

²⁷⁴ *Id.* at 294.

²⁷⁵ See *infra* Part V.

participation in the violation.”²⁷⁶ There is a logical problem with this assertion. The first case that he cites arrives at the conclusion, in a footnote, that vicarious liability for criminal acts under § 20(b) requires allegations of knowledge and participation in a complaint.²⁷⁷ Moreover, the support for this, which appears at best to be dicta, is derived from *Moss v. Morgan Stanley*, 553 F.Supp. 1347, 1362 (S.D.N.Y.), aff’d 719 F.2d 5 (2d Cir. 1983), which relied on *Sec. Exch. Comm’n v. Coffey*. Since that time, *Moss* has only been cited twice where Section 20(b) is mentioned. The first case states as follows: “few reported cases discuss the applicability of Section 20(b), but it is clear that the section requires a showing that a ‘controlling person knowingly used the controlled person to commit the illegal act.’”²⁷⁸ For support, *Cohen* relies on *Moss* and *Coffey*.²⁷⁹ However, because the reasoning of *Coffey* is unsupported, flawed, and likely to be overruled in the future, this is a weak position, and *Rush* does not provide meaningful support for Carter’s argument.

Regardless, Mr. Carter concludes that “[i]n practice ... Section 20(b) requires control, culpable participation, and a violation of the securities laws.”²⁸⁰ Consequently, he believes that “any exposure under section 20(b) would also generate exposure under Section 20(a).”²⁸¹ This reasoning is defective, however, because there are multiple differences between Section 20(a) and Section 20(b).²⁸² In spite of this, Carter assumes that “The only functional difference between the provisions is that the SEC can only use Section 20(b) when seeking injunctive relief.”²⁸³ This interpretation is erroneous and runs contrary to the majority of the reasoned logic applied by numerous commentators considering Section 20(b).

G. Andrew Gillman – 2012

Gilman suggests that one problem is that while Section 20(b) of the Exchange Act may provide a means to address the loopholes that *Janus Group v. First Derivative Trader*²⁸⁴ created, the Supreme Court does not provide guidance on

²⁷⁶ *Supra*, note 279, at 294..

²⁷⁷ See *Rush v. Oppenheimer & Co., Inc.*, 628 F. Supp. 1188, 1196 (S.D.N.Y. 1985).

²⁷⁸ *Cohen v. Citibank, N.A.*, 954 F. Supp. 621, 630 (S.D.N.Y. 1996).

²⁷⁹ See *id.*

²⁸⁰ *Supra*, note 279, at 294.

²⁸¹ *Id.*

²⁸² *Supra*, note 58.

²⁸³ *Supra*, note 279, at 294.

²⁸⁴ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

how to interpret the provision.²⁸⁵ In this regard, Gilman is correct and the Supreme Court will be left to address this open question in another case in the future. Nevertheless, Gillman asserts that *Janus* may be interpreted so that the investment advisor would avoid liability under § 10(b) and Rule 10b-5 since it did not have “ultimate authority” over the statement, and the directors would skirt liability because they did not “make” the statement.²⁸⁶ However, if the investment advisor makes the false statements “through” the innocent corporation, Section 20(b) would provide for liability against the investment advisor and fill the “loophole” that the *Janus* decision creates.²⁸⁷ This kind of thinking is entirely consistent with the history and scope of Section 20(b). As such, Gilman contends that applied to *Janus*, JCF may be viewed as the “dummy” corporation, while JCM provided all of the investment services necessary to operate the Funds.²⁸⁸ Additionally, plaintiffs would still have to prove that JCM “controlled” JCF rather than acted “by means of” the fund.²⁸⁹

Gillman’s article, which presents a thoughtful analysis of *Janus*, interestingly enough does not assert that plaintiffs would have to show “knowing use” that JCM controlled JCF.

H. Arnold S. Jacobs – 2014

Jacobs wrote about the divide in *Janus* between Justices Thomas and Breyer.²⁹⁰ First, he characterizes it as the majority believing Section 20(b) is limited to the use of innocent intermediaries, while the dissent views the Section 20(b) case law as undeveloped and believes Section 20(b) gives rise to a private right of action.²⁹¹ Second, in terms of the elements of a Section 20(b) claim, Section 20(b) is very much like the “directly or indirectly” Rule 10b-5 wording²⁹²

²⁸⁵ Andrew Gillman, *Scope of Primary Liability Under Section 10(b) of the Exchange Act and SEC Rule 10b-5 Following Janus Capital Group*, Volume 40, Issue 3, SEC. REG. L.J., 1 (2012).

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ *Id.*

²⁹⁰ See ARNOLD S. JACOBS, 5B DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 11:8 (2014).

²⁹¹ *Supra*, note 33, at 1.

²⁹² Both Section 10(b) and Rule 10b-5 begin: “It shall be unlawful for any person, directly or indirectly [to engage in proscribed acts].” See, ARNOLD S. JACOBS, *DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS* § 11:7 (2012).

because both address the liability of the source of a false statement when third parties disseminate that statement.²⁹³ Jacobs observes that there are three differences:

[(1)] Rule 10b-5 imposes no requirement that the intermediary be innocent, as Justice Thomas read into Section 20(b). Thus, Rule 10b-5 but not Section 20(b) covers two guilty persons acting in concert, one who creates the misleading statement and the other who acts as the intermediary and conveys it to the public. The source could be liable under Rule 10b-5 as we discussed for setting the lie in motion if the lie is attributed to him, and the person passing it on (the intermediary) could be held responsible because he “makes” the statement a second time when passing it on. Thus, there are two ultimate authorities, the person who was the ultimate authority at the source who decided to launch the misrepresentation and the person who was the ultimate authority at the intermediary who decided to pass on the misleading statement. When the source or intermediary is an entity, the entity or entities could be liable as well;

[(2)] Rule 10b-5 requires that the false statement be attributed to the source for the source to be liable. Section 20(b) contains no such requirement. Thus, when a source starts a false rumor in an attempt to manipulate a stock's price upward, the source can be held liable for the consequences of persons repeating the rumor under Section 20(b) whether or not the rumor is attributed to the source, but 10b-5 liability will be visited on the source only if the source is mentioned when the rumor is repeated; and,

(3) Rule 10b-5 may require more than attribution; it might require the plaintiff to prove something like the source intended the statement to be disseminated further, foresaw that the statement would be communicated to others, or did not restrict the use of the information to the original recipient. Courts may or may not read into Section 20(b) a similar requirement.²⁹⁴

Third, the majority declined to address the whether Section 20(b) created a private right of action, but the dissent clearly viewed that it does or it would not

²⁹³ *Id.*

²⁹⁴ *Id.* at §12:113:99.

have suggested a remand so that the plaintiff could add a Section 20(b) cause of action to its complaint.²⁹⁵

In evaluating this distinction, because joint and several liability referenced in Section 20(a) can arise in both private civil litigation and in SEC enforcement actions, Jacobs suggests that courts should reach the same conclusion regarding Section 20(b).²⁹⁶ “In addition, the Section 20(b) words ‘It shall be unlawful’ also are the first words in Rule 10b-5, which gives rise to a private right of action. . . . Even when no private right of action exists, Section 20(b) is an available remedy for SEC and criminal actions.”²⁹⁷ In light of this, Jacobs presents a strong argument that Section 20(b) claims are available in government enforcement actions by the SEC and for private individuals.

V. EVALUATING THE IMPACT OF *JANUS* AND THE FUTURE OF SECTION 20(b) CLAIMS

Since *Janus*, there have been eight reported decisions referring to Section 20(b). However, none of the cases resolve the open questions that exist:

- What does the legislative history reveal about the intent of the drafters of Section 20(b)?
- Why should the Sixth Circuit’s decision in *SEC v. Coffey* be overruled entirely?
- Are Section 20(b) claims viable in light of the Supreme Court’s recent decision in *Janus Capital Group, Inc. v. First Derivative Traders*?
- What elements are necessary to prove Section 20(b) claims?
- What kinds of Section 20(b) claims can we expect to see from FINRA and the SEC?

A. *The Scope and Intent of the Legislative History of Section 20(b)*

In considering the legislative history, the purpose of Section 20(b) was to prevent evasion of the provisions of the ’34 Act by hiding behind “dummies” and “dummy corporations” that would actually do the things forbidden by the law.²⁹⁸ As an example, Mr. Corcoran described a bank or a broker controlling a separate entity dealing in securities that would commit violations of the federal securities

²⁹⁵ *Id.*

²⁹⁶ *Id.*

²⁹⁷ *Id.*

²⁹⁸ Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the H. Interstate & Foreign Commerce Comm., 73d Cong. 228 (1934).

laws.²⁹⁹ The drafters made it explicitly clear that they did not want this kind of liability to be limited or narrowed, stating that it would be “impossible” to anticipate the many ways in which actual control may be exerted.³⁰⁰ Specific examples were offered by Representative Rayburn, including stock ownership, lease, contract and agency. Because the statute was drafted simply and brilliantly, Section 20(b) can and should be utilized to pursue other violations where actual or legally enforceable control are present.

Another example that was set forth by Ferdinand Pecora in his book “Wall Street Under Oath” is also useful because it demonstrates the complexity of situations involving dummies and control persons. Russell Brown was the Chairman of the Board of the American Commercial Alcohol Company (ACAC).³⁰¹ ACAC was organized in Maryland and Maryland law prevented the issuance of new stock for cash unless the shareholders were first given an opportunity to buy.³⁰² However, a loophole existed if newly issued stock was exchanged for that of another corporation.³⁰³ Thus, Brown’s friends, K.B. Phagan and C.C. Capdevielle, consented to act as dummies.³⁰⁴ Two corporations were formed, Maister Laboratories Incorporated (Maister) and Noxon, Incorporated (Noxon).³⁰⁵ Phagan gave a promissory note for \$180,000 for Maister and Capdevielle a promissory note for \$270,000 for Noxon.³⁰⁶ In exchange for the notes, Messrs. Phagan and Capdevielle received all the shares from Maister and Noxon, which they then exchanged with ACAC for 25,000 newly issued shares of its stock.³⁰⁷ While this technically complied with Maryland law, Brown’s motive was to manipulate the new shares to as high a price as possible.³⁰⁸ Accordingly, other associates of Brown were involved as dummies to

²⁹⁹ Stock Exchange Practices: Hearing on S. Res. 84, S. Res. 56, and S. Res. 97 Before the S. Banking & Currency Comm. 73d Cong. 7022 (1934).

³⁰⁰ Memorandum Re Amendments to Draft of April 3, 1934 – (First Committee Print), LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934 (Pub. L. No. 73-291, 48 Stat. 881 (1934), 15 U.S.C. 78).

³⁰¹ *Supra*, note 48.

³⁰² *Id.*

³⁰³ *Id.*

³⁰⁴ *Id.*

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.*

form a pool to stimulate interest in the stock and sell it to the public.³⁰⁹ Once the pool was in place, vigorous activity in buying and selling of the stock commenced.³¹⁰ From May 2, 1933 to July 18, 1933, the shares went from \$20 to \$89.³¹¹ In addition to the pool manager, a broker known as a “specialist” confined to a few particular stocks, was brought in to buy and sell the stock.³¹² The specialist, Wright, testified as follows:

MR. PECORA: And as a rule what is the object sought to be accomplished by those persons who organize a pool account in order to make a market in the stock?

MR. WRIGHT: To redistribute the stock at a higher price if possible.

MR. PECORA: That is, to raise the price level of the stock as much as possible?

MR. WRIGHT: Yes, sir.³¹³

The result of the pool’s operation was to net \$210,000 profit to the pool’s members, including Brown, but the public was left holding the bag after the stock price plummeted from \$89 to \$30 by July 22, 1933.³¹⁴ The public, not realizing that the stock was being manipulated, suffered massive losses as a result of the manipulation, while Mr. Wright personally earned his own separate profit of \$138,000 for the month of July 1933.³¹⁵

With the passage of Section 20(b), this would have provided government agencies and private individuals the ability to obtain relief from Brown as a controlling person for his control over the pool, the pool’s manager and the trading specialist.

B. *Why Sec. Exch. Comm’n v. Coffey Should Be Overturned Entirely*

Sec. Exch. Comm’n v. Coffey is an unusual decision for several reasons. Although the opinion contains thirty-four footnotes with references, the use of

³⁰⁹ *Id.*

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² *Id.*

³¹³ *Id.*

³¹⁴ *Id.*

³¹⁵ *Id.*

citations is abandoned *before* the discussion of Section 20(b) begins. This is noteworthy because the opinion sets forth no authority for many of the conclusions that are drawn about Section 20(b) and its scope and applicability to such claims. To be clear, this does not mean that the authority is disagreeable; rather, it is non-existent. What is especially troubling about this fact is that multiple cases have cited the decision favorably for numerous propositions concerning Section 20(b) that are unsupported, erroneous or outdated.

The first problem with *Coffey* is its determination that there is a requirement for “knowing use.” Stated differently, *Coffey* requires proof that the controlling person “knowingly used” the controlled person. However, the express language of Section 20(b) concerns unlawful acts and cannot reasonably be interpreted to include “knowing use” as a basis for liability. Another problem is that *Coffey* appears to suggest that Section 20(b) claims must have derivative liability. Concerning both of these issues, no such requirements were ever discussed in the legislative history of Section 20(b). In fact, even critics of Section 20(b) did not advance these arguments before the ’34 Act was passed. Also, no cases decided prior to *Coffey* ever imposed this condition. Regardless, in examining the “knowing use” requirement, a reasonable interpretation is that *Coffey* seeks to impose scienter as a prerequisite for liability. While common sense and logic mandate that a separate, underlying unlawful act, the proof of which requires scienter, must be proved with scienter, there is no justification or support for creating a separate and unique scienter requirement that applies to Section 20(b) claims. Moreover, such a condition is inconsistent with the goal of addressing control person liability because there are situations where violations of the federal securities laws occur where there is “knowing use.”

As an example, in the *Imbruce* case, Imbruce used Berkowitz to engage in prohibited short selling in violation of Rule 105. If FINRA had been required to prove that Imbruce “knowingly used” Berkowitz, it is unclear whether FINRA would have prevailed, assuming it pursued a Section 20(b) claim. While the hearing panel determined that Imbruce’s testimony was not credible, Imbruce denied instructing Berkowitz to short \$500,000 of ATPG’s stock to reduce the portfolio’s net long position. Without more evidence to resolve the “he said, he said” dispute between Imbruce and Berkowitz or evidence showing Imbruce’s state of mind, FINRA may not have had enough evidence to pursue a Section 20(b) claim if knowing use was imposed. The problem is that this creates a potential loophole for individuals to commit technical violations of the securities laws and then disclaim knowledge to avoid the imposition of Section 20(b). In light of the original purpose of Section 20(b), such a result would be contrary to the intent of the drafters.

The second problem with *Coffey* is that the Sixth Circuit concludes that “broad liability” for violations was not the congressional intent, but it also fails to provide any support for this position. In fact, one critic of Section 20(b) voiced the concern that control person liability should be limited where the controlling person “makes use of other persons” to evade the act.³¹⁶ Although this group’s opposition appeared to desire some kind of use, whether knowing or not, the drafters expressly rejected this argument. As a result, for anyone carefully examining this issue in the future, it will be extremely difficult to persuasively argue that the legislative intent of the drafters was to impose any use requirement, whether it is knowing or not.

The third issue with *Coffey* is the declaration that Section 20(b) cannot be used by the SEC except to pursue an injunction. Without conceding that this may have been an accurate statement in 1974, it is highly unlikely that this is a correct statement of law in 2014. This is because the opinion justified this based on 15 U.S.C. § 78u(e), which was re-designated as § 78u(d) and amended shortly after the decision was published.³¹⁷ Additionally, the laws concerning remedies and penalties have been revised multiple times since this case was decided. In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act (the “Remedies Act”), which, among other things, gave the SEC authority generally to seek civil money penalties in enforcement cases.³¹⁸ More recently, the amount and scope of remedies was vastly expanded by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) in 2010. Consequently, § 78u(d)(3) provides as follows:

Whenever ... any person has violated any provision of this chapter, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 78u-3 of this title, ... the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.³¹⁹

³¹⁶ *Supra*, note 25.

³¹⁷ LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934 (Pub. L. No. 94-29, 94th Congress, 89 Stat 97, (1975), 15 U.S.C. § 78).

³¹⁸ While Congress believed that these remedies continued to be important means of deterrence, it concluded that “the money penalties proposed in this legislation are needed to provide financial disincentives to persons from committing a wide range of securities law violations.” S. Rep. No. 101-337 (1999).

³¹⁹ 15 U.S.C. § 78u(d)(3).

Consequently, if the SEC can pursue a Section 20(b) claim in district court, then it may recover civil penalties. Nevertheless, even if the SEC is forced to pursue Section 20(b) claims in an administrative proceeding, this would not prevent the SEC from recovering civil penalties based on the statutory tier amounts. Thus, if the latter situation applies, then the SEC could not recover the gross amount of pecuniary gain to the defendant in the administrative forum.

The fourth problem with *Coffey* is that it held that the SEC could not pursue Section 20(a) claims and that it could only pursue Section 20(b) claims to seek injunctive relief. Nevertheless, Dodd-Frank overruled *Coffey* in part by specifically including the SEC as a “person” with standing to pursue both Section 20(a) and Section 20(b) claims.

C. *The Janus Decision Opens the Door to Section 20(b) Claims*

Based on the foregoing, there are multiple compelling reasons for the Sixth Circuit and ultimately, the U.S. Supreme Court, to overrule the *Coffey* decision, in the event that a party attempts to rely on *Coffey* or its progeny to justify the following:

- Imposing a “knowing use” requirement as a pre-requisite to establishing control person liability;
- Arguing that the legislative history discourages “broad liability” for violations;
- Dismissing a case brought by the SEC based on standing; and,
- Preventing the SEC from obtaining civil monetary penalties and other appropriate fines and remedies and relief beyond an injunction.

A plain reading of *Janus* demonstrates the Court’s interest in Section 20(b) claims as a means of alternate liability when others, such as Rule 10b-5, may be unavailable. In fact, one commentator, Gillman, artfully revisited *Janus*, viewing the framework with JCM as the investment adviser who “made” the statement – (as a controlling person) – and JCF acted as the dummy with “ultimate control” – (as the controlled person). However, Section 20(b) may also be greatly expanded in the future, as previously envisioned by the SEC in a multitude of situations, as seen in the next section.

D. *What Kinds of Claims May the SEC Bring to Enforce Section 20(b)?*

Oddly, if not remarkably, neither the SEC, nor FINRA nor any private individuals have pursued a Section 20(b) claim by itself, as a form of primary liability. One may infer that the SEC has historically chosen other means to pursue violators of the federal securities laws because of the “dearth” of reliable case law. Without precedent, this understandably creates a serious litigation risk

that a case could be defeated on a technicality if the opposing party successfully argues that Section 20(b) only provides derivative liability.

However, in considering the language of the legislative history, Section 20(b) should be utilized to pursue violators who use dummies, dummy corporations or hide behind others to evade liability. If the main purpose is to “catch the man who stands behind the scenes and controls the man who is in a nominal position of authority” then Section 20(b) provides a means of primary liability.³²⁰ One can imagine that this would be a desirable option for FINRA or the SEC in many different ways. As an example, if the “controlled person” is unavailable or untouchable because of jurisdictional constraints, then Section 20(b) would at least provide an opportunity to pursue the control person. Alternatively, if an investigation reveals that the controlled person will be a cooperative witness who agrees to testify against a controlling person, this may also merit the use of a Section 20(b) claim. On the other hand, if a government agency that decided that it wanted to target both the controlling person and the controlled person under joint liability, it could pursue a Section 20(a) claim.

Nevertheless, one potential roadblock in charging a Section 20(b) claim is the *Sec. Exch. Comm’n v. Stringer*³²¹ decision. As reviewed in Section III. B. IV, while *Stringer* acknowledged that Section 20(b) entitles claims based on unlawful activity through or by means of other persons, it also stated, without support, that “[b]oth Sections 20(a) and 20(b) create secondary liability.”³²² Lumping Sections 20(a) and Section 20(b) together, the court concluded, a second time that, “[b]oth sections impose secondary liability on persons who act by and through others.”³²³ The problem is that these comments, which are arguably dicta, and if so, should be ignored as they do not have precedential value, do not cite to the legislative history or any cases whatsoever for support. Consequently, it remains to be seen at a future date how Section 20(b) claims will be characterized. Ideally, the Supreme Court will do the necessary legwork and research to reach the most reasonable conclusion that Section 20(b) claims may be pursued as a primary means of liability.

Furthermore, in order to analyze a Section 20(b) claim according to its respective elements for proof, one can envision that the federal courts will

³²⁰ 78 CONG. REC. 8095.

³²¹ *Sec. Exch. Comm’n v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011 at *1 (D. Or. Sept. 3, 2003).

³²² *Id.* at *6.

³²³ *Id.* at *15.

eventually construct a three-part test, as follows, to require proof of a Section 20(b) claim:

- A controlling person or persons, whether acting as a dummy, dummy corporation, agent or real party in interest;
- Who exercise(s) some form of actual or legally enforceable control over another who is a controlled person; and,
- The commission of an unlawful act that violates the federal securities laws.

Alternatively, to establish control, which will be fact intensive, one may set forth proof that there was some form of “realistic control” proposed by Kuehnle that is also consistent with 17 C.F.R. § 240.12b-2. In terms of the contours of when the control may end, the legislative history makes it clear that a company that cedes control of a separate entity will not be subject to control person liability for violations that occur after the control ends.³²⁴

Looking ahead, while there are many claims that could fall under the broad power envisioned by Section 20(b), which has been given new life by the expansion of penalties under the 1990 Remedies Act and other legislation enacted during the past twenty years, as well as the *Janus* decision, the SEC has already quietly contemplated Section 20(b) claims for other additional violations throughout the past fourteen (14) years, as we will see in the next sub-sections.

1. Using Derivatives to Evade Rule 105

As part of a proposed rule concerning short selling, the SEC makes it explicitly clear that using derivatives as a part of trading strategies designed to evade the application of Rule 105 does not comply with Commission rules.³²⁵ As an example, the Commission notes that some persons may attempt to skirt Rule 105 by “claiming to have a position in a security by virtue of having entered into a ‘married put’ transaction when in fact their transactions were the equivalent of short sales, for which they used shares acquired in the offering to close-out their restricted period sales.”³²⁶ Section 20(b) of the Exchange Act prohibits this type of conduct. The Commission has also noted that:

³²⁴ Stock Exchange Practices: Hearing on S. Res. 84, S. Res. 56, and S. Res. 97 Before the S. Banking & Currency Comm., 73rd Congress 7022 (1934).

³²⁵ Securities and Exchange Commission, *Short Selling in Connection With a Public Offering*, Release No. 34-54888, 89 S.E.C. Docket 1346, 2006 WL 3523646 (2006).

³²⁶ *Id.*

purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of Section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder.³²⁷

During the rule comment period, the New York Stock Exchange wrote to advocate its support for the rule:

Given the proliferation of this intentional manipulation of the market, the NYSE supports efforts by the industry to address the use of derivatives to disguise illegal covering activity. The focus of these efforts should be to expose activities that intentionally circumvent the prohibitions of Rule 105 or otherwise manipulate the market around an offering of securities. These efforts should, at a minimum, evaluate trading strategies using a sampling of different types of derivatives and assess the consequences of such conduct on the market, issuers and investors. Results from an industry effort to expose these strategies will allow the Commission and the securities industry, at large, to determine whether future rulemaking is necessary with respect to derivatives in this area.³²⁸

Similar to the *Imbruce* decision, it is easy to envision that there will be future violations where options are used by controlling persons to engage in violations of Rule 105 that trigger Section 20(b) liability.

2. Potential Violations of Regulation Fair Disclosure Triggering Section 20(b) Claims

Under Section 20(b) of the Exchange Act, a senior manager who directs another person to make the disclosure may be held liable for a claim under Section 20(b) and Regulation Fair Disclosure (which is treated as 13(a) claim). Under the Final Rule on selective disclosure and insider trading, the SEC established that “neither an issuer nor such a covered person could avoid the reach of the regulation merely by having a non-covered person make a selective

³²⁷ *Id.*

³²⁸ Richard Ketchum, Chief Executive Officer, NYSE Regulation, Inc., *Comment on Proposed Rule, Short Selling in Connection With A Public Offering*, 2007 WL 2073524 (2007).

disclosure.”³²⁹ Therefore, Section 20(b) prohibits a senior official from escaping liability “by directing non-covered personnel to make a selective disclosure of information to someone within the classes of enumerated recipients. In such a case, the senior officer would be held responsible for making the selective disclosure.”³³⁰ In essence, the senior manager would be viewed as the controlling person and the “other” employee as the one who is controlled. Finally, the definition of a “person acting on behalf of the issuer” specifically excludes an “officer, director, employee, or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to an issuer.”³³¹ Accordingly, “[i]n this situation, the issuer would not be held responsible under Regulation FD for its employee's actions.”³³²

3. Falsification of Accounting Records May Trigger Section 20(b) Violations

Pursuant to 17 C.F.R. § 240.13b2-1, which concerns the falsification of accounting records: “No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.” By including the term “indirectly” the statute, as codified, includes a reference to multiple other provisions of the federal securities laws, including Section 20(b).³³³ As a result, this provides another means to establish liability for Section 20(b) claims.

4. Regulation AC May Present Opportunities for Section 20(b) Claims

In 2003, the SEC issued the final rule on Regulation AC, which requires:

that brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views.³³⁴

³²⁹ Securities and Exchange Commission, *Final Rule: Selective Disclosure and Insider Trading*, <http://www.sec.gov/rules/final/33-7881.htm> (last visited March 5, 2014).

³³⁰ *Id.* at 178.

³³¹ *Id.* at 178-79.

³³² *Id.*

³³³ 15 U.S.C. § 78t(b).

³³⁴ Securities and Exchange Commission, *Regulation Analyst Certification*, <http://www.sec.gov/rules/final/33-8193.htm> (last visited April 28, 2014).

In a footnote in the release, it explains that “Regulation AC is directed at those regulated persons that prepare research reports, as well as persons associated with regulated persons who might be used if attempts were made to improperly circumvent the rule.”³³⁵ Also, this statement refers to Section 20(b) in anticipation of such claims based on Regulation AC violations.

CONCLUSION

Similar to many of the other provisions of the '34 Act, Section 20(b) was created to address unlawful activity affecting the markets. It provides a specific means for government agencies to “catch the man behind the man” to prevent violators from evading liability. Also, the legislative history supports a broad, rather than narrow, purpose behind the law as a means of primary liability. This article is intended to frame the discussion so that the federal courts will treat Section 20(b) claims distinctly from Section 20(a) claims and to properly evaluate Section 20(b) claims on their own right and in their own context. With restrictions on insider trading as a result of the *Janus* decision, government agencies should consider utilizing and implementing Section 20(b) to obtain relief. If doing so ultimately protects investors, then this also supports one aspect of the SEC’s tri-partite mission. By extension, if prevailing on such claims results in relief for the government and possibly the investing public, this should also deter future violations of the federal securities laws.

³³⁵ *Id.* at n.44.