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Implied Private Right of Action Under Section 17 of the Securities Exchange Act of 1934

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RECENT DEVELOPMENTS

Implied Private Right of Action Under Section 17 of the Securities Exchange Act of 1934

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I. INTRODUCTION

The Securities Exchange Act of 1934[1] created the Securities and Exchange Commission (SEC) and vested it with broad regulatory and enforcement powers. While one of the purposes of the Act is to protect investors,[2] the SEC has long recognized that it lacks the resources to fully accomplish that goal.[3] Consequently, plaintiffs injured by actions in violation of the Act have sought remedies in the federal courts that have been willing to imply private rights of action under the securities laws.[4] Recently, however, the Supreme Court has indicated that it will restrict the scope of remedies available to private litigants, thus creating confusion about implication,[5] particularly in the field of securities. Despite this trend, the Second

1. 15 U.S.C. § 78 (1976).

2. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426 (1964); text accompanying notes 18-20 *infra*.

3. *See* note 99 *infra*.

4. *See* note 41 *infra*.

5. The term "implication" is used here to describe the judicial process of finding a right of action in favor of plaintiffs under statutes that do not expressly provide a private remedy.

Circuit has recently implied a remedy in favor of private litigants under two securities statutes that previously had not been read to create a right of action.[6] This apparent conflict between the Supreme Court and the Second Circuit underlines existing uncertainty concerning the continued availability of implied remedies and emphasizes the need for a sound analytical framework within which courts can produce consistent results in implication. This Recent Development will review implication in the securities area, focusing on the most recent Second Circuit decision[7] creating an implied remedy under section 17 of the Securities Exchange Act of 1934, and analyzing the scope of that remedy and its impact on potential private litigants.

II. LEGAL BACKGROUND

A. *Standards for Implication*

The Supreme Court first indicated the existence of implied private rights of action in *Texas & Pacific Railway Co. v. Rigsby*,[8] when it held that a railroad employee injured by railroad equipment that did not meet the standards of the Federal Safety Appliance Act[9] had a cause of action against the railroad, despite the fact that the Act did not expressly provide a private remedy.[10] The Court stated that when disregard of a statutory command results in damage to a party "for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . . ."[11] This principle suggested that a federal private right of action might be implied for anyone injured as a result of a statutory violation.[12] Although the rule announced in *Rigsby* swept broadly, it was not applied extensively by the federal courts until recently.[13]

6. *See* Redington v. Touche Ross & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. April 21, 1978); Ahrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 2253 (1978).

7. Redington v. Touche Ross & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. April 21, 1978).

8. 241 U.S. 33 (1916).

9. Federal Safety Appliance Act, ch. 196, 27 Stat. 531 (1893) (current version at 45 U.S.C. §§ 1-43 (Supp. V 1975)).

10. In its analysis the Court relied on a proviso in § 4 of the 1910 amendment to the Act, ch. 160, 36 Stat. 298, which stated that nothing in the section shall he construed to relieve a carrier from liability in any remedial action for the death or injury to any railroad employee caused by equipment that is either defective or otherwise not in accordance with the specifications of the Safety Appliance Act. 241 U.S. at 39-40.

11. *Id.* at 39.

12. The principle has since been adopted by the RESTATEMENT (SECOND) OF TORTS § 286 (1965).

13. The best known of the few early implied cases include Tunstall v. Brotherhood of Locomotive Firemen, 323 U.S. 210 (1944); Reitmeister v. Reitmeister, 162 F.2d 691 (2d Cir.

Thus federal courts had little opportunity to develop a more practicable analytical framework for determining whether private remedies could be implied under federal statutes not expressly providing them. For a time the Court indicated that implied remedies might be restricted to statutes manifesting congressional intent to provide a private right of action,[14] but it reversed this trend in the landmark decision of *J.I. Case Co. v. Borak.*[15]

Plaintiff in *Borak* was a shareholder seeking relief under section 14(a) of the Securities Exchange Act of 1934[16] for damages resulting from a merger accomplished by the circulation of allegedly false and misleading proxy information. Noting that section 27 of the Act[17] grants the district courts jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created" under the Act, the Court concluded that private parties are entitled to bring suit for conduct allegedly violative of section 14(a).[18] The Court reviewed the legislative history of section 14(a) and determined that although the section makes no reference to a private right of action, the chief purpose of the Act is the protection of investors, "which certainly implies the availability of judicial relief where necessary to achieve that result."[19] The Court further observed that when private enforcement of SEC rules provides a necessary supplement to the Commission action, the courts have a duty to make such remedies available as are necessary to implement congressional purposes.[20] This emphasis on congressional purpose was expanded in *Allen v. State Board of Elections,*[21] in which the Court held that private plaintiffs may invoke the jurisdiction of federal courts to enforce section 5 of the Voting Rights Act of 1965.[22]

1947); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); Neiswonger v. Goodyear Tire & Rubber Co., 35 F.2d 761 (N.D. Ohio 1929).

14. 63 NW. U.L. REV. 454, 457-58 (1968). *See also* Wheeldin v. Wheeler, 373 U.S. 647, 651-52 (1963); T.I.M.E. Inc. v. United States, 359 U.S. 464, 471 (1959); Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 457 (1957).

15. 377 U.S. 426 (1964).

16. 15 U.S.C. § 78n (1976)(§ 14(a) makes it unlawful for any person to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any registered security in violation of rules and regulations promulgated by the SEC under § 12).

17. *Id.* § 78aa.

18. 377 U.S. at 430-31.

19. *Id.* at 432.

20. *Id.* at 433.

21. 393 U.S. 544 (1969).

22. 42 U.S.C. § 1973c (Supp. V 1975). This section provides that if a state covered by the Voting Rights Act passes any "voting qualifications or prerequisite to voting, or standard, practice, or procedure with respect to voting different from that in force or effect on November 1, 1964," no person can be deprived of his right to vote for failure to comply with the new enactment unless and until the state seeks and receives a declaratory judgment in the United States District Court for the District of Columbia that the new enactment "does not have

The *Allen* Court stated that private litigants must be allowed a right of action in order to effectuate the broad purpose of the Act to secure voting rights for all persons.[23] Recognizing the potentially broad reach of the approach taken in *Allen*,[24] however, the Court attempted to develop a more rigorous analytical framework for determining the existence of private rights of action in statutes silent on the subject in two leading cases: *National Railroad Passenger Corp. v. National Association of Railroad Passengers (Amtrak)*[25] and *Cort v. Ash*.[26]

In *Amtrak* the National Association of Railroad Passengers brought suit to enjoin the discontinuance of certain passenger rail routes, alleging that the discontinuance would violate the Amtrak Act.[27] In denying relief, the Court relied upon the principle of statutory construction stating that when the express language and history of a statute provide exclusive remedies for its violation, no additional private rights may be implied.[28] Thus, after extensive review of the legislative history of the Amtrak Act, the Court determined that section 307(a) created a public right of action in the Attorney General and that the only private right of action contemplated by the Act was expressly limited to labor disputes.[29] *Amtrak* therefore established a presumption against implication when a remedial scheme is expressly provided by Congress, rebuttable only by a showing of affirmative congressional intent to provide a private remedy.[30] Although *Amtrak* failed to develop a rigid test defining when a private cause of action should be implied, it narrowed the scope of inquiry by suggesting three gniding factors: legislative history, congressional purpose, and tenets of statutory construction.

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the purpose and will not have the effect of denying or abridging the right to vote on account of race or color."

23. 393 U.S. at 556-57.

24. *See generally* 17 B.C. INDUS. & COM. L. REV. 53, 58 (1975)(pointing out that if this kind of approach was literally followed it would almost always justify implying a remedy).

25. 414 U.S. 453 (1974).

26. 422 U.S. 66 (1975).

27. 45 U.S.C. §§ 501-644 (1970 & Supp. V 1975). The Act prohibited a railroad from discontinuing intercity passenger service prior to January 1, 1975, unless it entered into a contract with Amtrak pursuant to § 561(a)(1). Once a contract was entered into, however, the railroad could discontinue the service by filing a 30-day notice of intent. *Id.* § 564(a) (Supp. V 1975).

28. 414 U.S. at 458.

29. *Id.* at 457. The Court was also influenced by the fact that Congress specifically envisioned elimination of certain rail routes, the precise matter challenged by plaintiff, noting that implying a private remedy would undercut one of the purposes of the Act. *Id.* at 461-62.

30. *See* Comment, *Private Rights of Action Under* Amtrak *and* Ash: *Some Implications for Implication*, 123 U. PA. L. REV. 1392, 1402 (1975).

In *Cort v. Ash*[31] plaintiff-shareholders brought suit against a corporate director for alleged violations of the Federal Election Campaign Act.[32] In an effort to further develop and clarify the implication analysis, the Court identified four criteria relevant in determining whether a private remedy is implicit in a statute not expressly providing one:

> First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted," . . . that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?[33]

The Court found that none of the criteria were met, emphasizing that the Federal Elections Commission was charged with exclusive enforcement of the challenged statute and that the remedy sought would not further the primary congressional objective.[34] Although the *Ash* criteria provide a useful focus on questions that must be resolved before a private remedy may be implied under a federal statute, they fail to develop a rigorous test for implication. The relative significance of each of the criteria is undefined, and the Court's analysis failed to indicate whether all four must be met before a private remedy will be implied.[35] Thus, while *Borak*, *Amtrak*, and *Ash* provide federal courts with a number of factors to consider in determining whether a statute provides for an implied right of action, no guidance has been given regarding the proper application of those factors.

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31. 422 U.S. 66 (1975).

32. Federal Election Campaign Act, ch. 645, 62 Stat. 723 (1948)(current version at 2 U.S.C. § 441b (1976)) (making it unlawful for a corporation to make a contribution or an expenditure in connection with any presidential or vice presidential election).

33. 422 U.S. at 78 (emphasis in original). Regarding the first criterion, the Court noted that when a right of action has been found there has generally been a clearly articulated federal right in the plaintiff (citing Bivens v. Six Unknown Federal Narcotics Agents, 403 U.S. 388 (1971)), or a pervasive legislative scheme governing the relationship between the plaintiff and the defendant (citing *Borak*). 422 U.S. at 82.

34. *Id.* at 74-76, 80-84.

35. Commentators have suggested that there is little that is new in the *Ash* test, save for the last criterion, indicating that the first factor expresses the same concern as the congressional purpose analysis of *Borak*, and that the second and third are restatements of *Amtrak*. 17 B.C. IND. & COM. L. REV. 53, 62 (1975). *See also* Note, *Private Causes of Action Under Section 206 of the Investment Advisers Act*, 74 MICH. L. REV. 308 (1975).

B. *Implied Remedies Under the Securities Laws*

Until recently, the federal securities laws have been a fertile source of implied private rights of actions although these statutes are regulatory in function and provide only criminal sanctions. In the leading decision of *Kardon v. National Gypsum Co.*[36] the district court implied a private remedy under section 10(b)[37] and rule 10b-5[38] of the Securities Exchange Act of 1934, emphasizing the broad purpose of the 1934 Act to regulate securities transactions, protect investors, and eliminate fraudulent conduct. Noting the absence of a specific statutory denial of a private remedy, the court supported its holding under tort[39] and contract[40] theories. This decision served as the basis on which lower federal courts found implied private actions under the securities statutes[41] until the Supreme Court finally addressed the issue in *J.I. Case Co. v. Borak.*[42] The Court's subsequent recognition of an implied private remedy under section 10(b),[43] coupled with *Kardon,* vastly increased judicial recognition of plaintiffs' rights under that section.[44]

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36. 69 F. Supp. 512 (E.D. Pa. 1946).

37. 15 U.S.C. § 78j(b) (1976). Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

38. 17 C.F.R. § 240.10b-5 (1977) makes it unlawful:

> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in tbe light of the circumstances under which they were made, not misleading or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

39. 69 F. Supp. at 513-14. The court reasoned that § 10(b) created federal rights, the violation of which was actionable under tort law.

40. *Id.* at 514. Section 29(b) of the Act provides that contracts in violation of any provision of the Act shall be void. 15 U.S.C. § 78cc(b) (1976).

41. A partial list of securities law provisions under which courts bave implied private remedies may be found in Franklin Nat'l Bank v. L.B. Meadows & Co., 318 F. Supp. 1339, 1341-42 (E.D.N.Y. 1970).

42. 377 U.S. 426 (1964). *See* text accompanying notes 15-20 *supra.*

43. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 156-57 (1972) (material misrepresentation of seller's shares); Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 13-14 (1971) (scheme to purchase shares with ultimately worthless assets).

44. Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings,* 65 GEO. L.J. 891, 892 (1977). Lowenfels attributes this growth to expansion of the substantive scope of § 10(b) via recognition of novel causes of action. *See id.* at 892 n.3 (collection of cases recognizing implied rights of action under securities laws).

In a recent series of decisions under the securities laws, however, the Supreme Court has demonstrated an intent to restrict the availability of implied private rights of action. The Court has justified this retrenchment with a number of different rationales. For example, in *Securities Investor Protection Corp. v. Barbour*[45] customers of a failing broker-dealer sought to compel SIPC to discharge its obligations under the Securities Investor Protection Act (SIPA).[46] In refusing to imply a private remedy for plaintiffs, the Court determined that Congress had manifestly intended that enforcement of SIPA be restricted to the SIPC and had provided that only the Securities Exchange Commission could compel SIPC to act. The Court thus concluded that a private action was incompatible with the overall regulatory scheme created by SIPA.[47] The *Barbour* Court distinguished *Borak* on the grounds that SIPA, unlike the 1934 Act,[48] does not contain any "standards of conduct that a private action could help to enforce" nor any "general grant of jurisdiction to the district courts."[49] Similarly, the Court distinguished *Allen*[50] by stressing that unlike the Voting Rights Act, SIPA does not impose "such burdens on the parties charged with its administration" that Congress would have intended supplemental enforcement by private parties.[51] Despite these arguments, *Barbour* remains the only recent case in which the Court clearly refused to imply a private right of action under a particular securities statute.[52]

While complete denial of implied securities law remedies is thus rare, the Court has strongly indicated that it will restrict the scope of existing causes of action by strictly construing those securities statutes under which implied remedies have been previously recognized. Three specific cases demonstrate the Court's emphasis on the substantive elements and scope of a cause of action that has

45. 421 U.S. 412 (1975).

46. 15 U.S.C. §§ 78aaa-111 (1976). SIPC was created by SIPA in order to protect customers of failing brokers. *Id.* § 78eee. The House report accompanying SIPA noted that serious and persistent financial difficulties of broker-dealers lead to loss of investor funds and confidence. H.R. REP. No. 1613, 91st Cong., 2d Sess. 1-2, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 5255, 5255.

47. 421 U.S. at 420-21. The Court also stressed that allowing a customer to bring an action to compel liquidation of a firm could prove fatal to that firm, which might have met its difficulties through less drastic means. *Id.* at 421-23.

48. *See* text accompanying note 17 *supra.*

49. 421 U.S. at 424.

50. *See* text accompanying notes 21-22 *supra.*

51. 421 U.S. at 425.

52. In Piper v. Chris-Craft Indus., 430 U.S. 1 (1977), the Court refused to imply a private remedy in favor of a class held not to be protected, but explicitly left open the question whether the class protected under the statute has an implied cause of action, stressing the limited nature of its holding. *Id.* at 42 n.28. *See* text accompanying notes 71-74 *infra.*

already been implied. In *Ernst & Ernst v. Hochfelder*[53] the Supreme Court granted certiorari "to resolve the question whether a private cause of action for damages will lie under § 10(b) and rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud."[54] Customers of a brokerage firm brought suit under section 10(b) against the firm's accountants on a negligence theory—failure to discover fraudulent practices of the broker. While the Court agreed that rule 10b-5 imposes a duty on accountants,[55] it nonetheless barred the plaintiffs' claim on the ground that private actions for damages under section 10(b) must allege scienter.[56] The Court purported to base its holding solely on the language of the statute and rule and the accompanying legislative and administrative history, insofar as it clarified the meaning of the statutory wording, declining to consider the policy and purpose underlying the statute.[57] *Hochfelder* clearly increases the burden on plaintiffs seeking to state a cause of action under section 10(b), restricting litigant access to federal courts and discouraging strike suits.[58]

The Court extended this strict constructionist approach to analysis of congressional purpose in *Santa Fe Industries v. Green.*[59] Plaintiff-shareholders brought a section 10(b) claim alleging a breach of fiduciary duty by the majority shareholder in effecting a merger, but made no allegations of deceit or manipulation. The Court first noted that a claim alleging mere breach of fiduciary duty is insufficient under the express language of section 10(b).[60] The Court then applied the *Ash* criteria, finding the third and fourth factors unsatisfied. Since fairness of a transaction was only a tangential concern of section 10(b), implying a remedy would be inconsistent with the legislative scheme. Furthermore, since existing

53. 425 U.S. 185 (1976).

54. *Id.* at 193.

55. The origin of the duty imposed on accountants remains unclear because the Court did not discuss the Seventh Circuit's holding on that issue. The Seventh Circuit found that the accounting firm owed a duty to plaintiffs by basing its interpretation of rule 10b-5 on the broad policy requirements of § 17 of the Securities Exchange Act of 1934, 17 C.F.R. § 240.17a-5 (1976), and SEC Release No. 3338 (Nov. 28, 1942), issued pursuant to that rule. Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 216 n.21 (1977).

56. 425 U.S. at 193.

57. *Id.* at 214 n.33. The Court focused on the term "manipulative," reasoning that it is a word of art connoting intentional or willful conduct, not negligence. *Id.* at 199.

58. Lowenfels, *supra* note 44, at 899. "The thrust of *Hochfelder* is narrow, strict constructionist, and defendant oriented. The words and construction of the relevant statute are decisive. Legislative history is also relevant. Policy arguments, however, have no place in this vital holding." *Id.* at 900.

59. 430 U.S. 462 (1977).

60. *Id.* at 472-74.

state corporation law provided adequate relief to plaintiffs, an implied right of action was unnecessary to effectuate congressional purpose.[61] It is interesting to note that although the *Hochfelder* decision was sufficiently narrow to obviate the need for further supportive rationale, the Court felt compelled to reach the issue whether an implied right of action to enforce fair transactions exists under section 10(b). Thus the holding in *Santa Fe* represents a conscious effort to limit expansion of implied remedies under 10(b). In *Rondeau v. Mosinee Paper Corp.*[62] plaintiff corporation sought injunctive relief based on an alleged violation of section 13(d) of the 1934 Act.[63] The Court noted that even when a private remedy has been implied, plaintiffs must still establish irreparable harm and the other prerequisites for obtaining equitable relief.[64] Examining the purpose of section 13(d) the Court concluded that "none of the evils to which the Williams Act was directed has occurred or is threatened in this case."[65]

The Court has also indicated that it will strictly adhere to statutory standing requirements before sustaining an implied cause of action under the securities laws. In *Blue Chip Stamps v. Manor Drug Stores*[66] plaintiffs charged that they were purposely dissuaded from purchasing securities by an overly pessimistic appraisal of defendant's business and sought relief under section 10(b). The Court ruled that a private damages action under rule 10b-5 is restricted to actual purchasers or sellers of securities,[67] noting that when Congress has created remedies for others than purchasers it has done so expressly.[68] The Court also recognized the increased opportunity for vexatious litigation and strike suits for speculative damages should standing requirements not be rigidly enforced.[69] Although such re-

61. *Id.* at 477.

62. 422 U.S. 49 (1975).

63. 15 U.S.C. § 78m(d) (1976). Section 13(d) requires anyone who acquires a 5% or greater share of a class of stock to file reports with the SEC revealing the identity of persons for whom the purchases were made, the source of the funds used to make the purchases, the purpose of the acquisitions, the number of shares owned, and any information regarding arrangements with other persons relating to such purchases.

64. 422 U.S. at 64-65.

65. *Id.* at 59. The Court carefully noted that it has not hesitated to imply a private remedy "when to do so is consistent with the legislative scheme and necessary for the protection of investors as a supplement to enforcement hy the Securities and Exchange Commission." *Id.* at 62.

66. 421 U.S. 723 (1975).

67. The purchaser or seller requirement was first expressed in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

68. 421 U.S. at 734 (citing § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976), which allows issuer to recover insider profits).

69. 421 U.S. at 739-42.

strictions doubtlessly exclude some meritorious claims by persons intended to be protected under section 10(b),[70] the purchaser or seller requirement provides a necessary and workable standing criterion to potential litigants by restricting implied rights of actions to plaintiffs who can make a tangible showing of actual injury.

A focus on the first *Ash* factor—limiting implied remedies to the class of persons sought to be protected by a statute—underlined the Court's decision in *Piper v. Chris-Craft Industries.*[71] Plaintiff was a tender offeror who brought a claim under section 14(e) of the 1934 Act.[72] In holding that a tender offeror has no implied cause of action under section 14(e), the Court initially emphasized that Congress sought to protect only the shareholders of a target corporation, not tender offerors.[73] The Court went on to apply the remaining *Ash* factors, finding that none warranted implying a private remedy and that existing state laws should supply the appropriate remedy.[74] In view of the Court's holding concerning the scope of intended congressional protection,[75] it is unclear why the remaining *Ash* criteria were discussed at all. Once the Court determined that plaintiff was not "of the class for whose especial benefit the statute was enacted,"[76] it need not have applied the remaining factors of *Ash,* which seek to determine whether the statute contemplates an implied right of action at all, rather than whether such an action might lie in favor of the plaintiff.

The problems encountered by the Court in *Chris-Craft* highlight the difficulties inherent in a mechanical application of the *Ash* analysis. A court confronted with a plaintiff seeking relief under a statute that does not expressly provide a remedy must resolve three separate but overlapping questions. First, can a private right of action ever be implied under the statute, the issue facing the Court in *Barbour.* Second, does the plaintiff have standing to bring such an action, the problem present in *Blue Chip* and *Chris-Craft.* Third, assuming that an implied remedy exists, is the claim asserted by plaintiff within the scope of the right of action that may

70. Lowenfels, *supra* note 44, at 896.

71. 430 U.S. 1 (1977).

72. 15 U.S.C. § 78n(e) (1976). Section 14(e) makes unlawful "any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . or any solicitation of security holders in opposition to or in favor of any such offer . . . ."

73. The Court observed that "a party whose . . . conduct was purposefully brought under federal control by the statute . . . can scarcely lay claim to the status of 'beneficiary' whom Congress considered in need of protection." 430 U.S. at 37.

74. *Id.* at 38-41.

75. *See* note 52 *supra.*

76. *See* text accompanying note 33 *supra.*

be implied, the focus of *Hochfelder, Mosinee Paper,* and *Santa Fe.* The *Ash* analysis is relevant primarily to the first question,[77] although the "class to be protected" factor is useful in considering the standing issue as well. The failure to distinguish clearly between these three issues has led to inappropriate application of the *Ash* analysis in cases such as *Santa Fe*[78] in which an implied right of action was previously found to exist. The better approach would be to utilize the analyses suggested in *Borak, Amtrak,* and *Ash* only to determine whether a private right of action exists under a particular statute. Once this initial determination is made, an application of the relevant statutory standing requirements and substantive limits on the scope of the cause of action is appropriate. This distinction between the existence of a right of action and the parameters of that action demonstrates that although recent Supreme Court decisions substantially curtail the scope of remedies available to private litigants,[79] they by no means foreclose the possibility of implying private rights of action under the securities laws.

III. Recent Treatment of Implication by Lower Federal Courts

In three recent cases the Second Circuit has addressed the problem of implying a private remedy under the securities laws. In *Lank v. New York Stock Exchange*[80] the receiver of a liquidated stock exchange member sought damages on behalf of the member corporation allegedly sustained as a result of the exchange's failure to force the member to comply with the exchange's rules. The suit was brought under section 6 of the 1934 Act.[81] The court noted that an implied remedy had been found under section 6,[82] but nonetheless held that a securities exchange is not liable to a member organization for failure to force the members to comply with its rules.[83] The court relied on the first *Ash* factor finding that, because neither the Act nor its legislative history evidenced any intent to benefit the members of the exchange,[84] the intended beneficiary class of the

77. *See* 422 U.S. at 78.

78. *See* text accompanying notes 59-61 *supra.*

79. *See, e.g.,* Lowenfels, *supra* note 44.

80. 548 F.2d 61 (2d Cir. 1977).

81. 15 U.S.C. § 78f(b) (1976). Section 6 requires that national securities exchanges enforce their rules against member organizations in order to be registered with the SEC.

82. *See* New York Stock Exchange v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975), *quoted in* 548 F.2d at 66.

83. 548 F.2d at 66. The court concluded that if the member has no cause of action, its receiver cannot have one, since he can assert no more than the member could have. *Id.* at 67.

84. *Id.* at 65.

1934 Act was restricted to public investors. *Lank* illustrates that the first *Ash* factor may be properly used in resolving the standing issue even when no question of implying a right of action is present.

In *Abrahamson v. Fleschner*[85] limited partners in an investment partnership sought damages from the partnership, its accountants, and the general partners for failure to disclose certain information, allegedly in violation of section 206[86] of the Investment Advisers Act of 1940.[87] In determining whether an implied right of action exists under the Advisers Act, the court implemented the *Ash* criteria, finding that (1) plaintiffs, as advisers' clients, were intended beneficiaries of the Advisers Act, (2) the legislative history was silent on the issue of a private remedy, (3) a failure to recognize a private remedy would frustrate congressional purpose, since the SEC's resources were insufficient to assure effective regulation,[88] and (4) although the general jurisdictional provision of the Advisers Act referred only to suits in equity, it should not be narrowly construed to preclude a private right of action.[89] The court thus held that there is an implied right of action under section 206 of the Advisers Act.[90] Having created the private remedy, the court refused to subject plaintiffs to the purchaser-seller requirement of *Blue Chip*, reasoning that the Advisers Act does not contain such a requirement, and that Congress intended to protect advisers' clients irrespective of whether they purchase or sell shares.[91] While *Abrahamson* has been criticized,[92] it suggests a useful approach to the implication problem

85. 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 2253 (1978).

86. 15 U.S.C. § 80b-6 (1976). Section 206 provides in relevant part:

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

. . . .

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

87. Plaintiffs also claimed under § 10(b) of the 1934 Act. The court rejected this claim because neither the reconstitution of the partnership nor the fraudulent inducement not to sell plaintiffs' partnership interest constituted the purchase or sale of a security. 568 F.2d at 868.

88. The court stated that an intent to vest the SEC with exclusive enforcement of the securities laws will not be readily made, distinguishing *Barbour*. *Id.* at 874 n.19.

89. *Id.* at 873-76.

90. *Id.* at 876.

91. *Id.* at 877.

92. One commentator suggested that the remedy created was unduly broad and failed to provide necessary limitations, imposing a potentially excessive liability on advisers and

by clarifying the distinction between implying a private remedy and allowing a particular plaintiff a cause of action under that remedy. The opinion also provides alternative relief for plaintiffs foreclosed by the increasing barriers erected in section 10(b) actions.

In *Redington v. Touche Ross & Co.*[93] plaintiffs, a trustee in liquidation and the SIPC,[94] sought damages under section 17 of the 1934 Act[95] from an accounting firm for preparing false and misleading certifications of a broker's financial condition.[96] In determining whether a private cause of action exists under section 17, the court first determined that the section imposes a duty on accountants.[97] As in *Abrahamson,* the court applied the *Ash* factors and found that (1) section 17 and the rules promulgated thereunder were intended to protect brokers' customers, (2) the legislative history was silent on whether a private remedy should be implied,[98] (3) since reliance on accountants' reports is necessary under section 17, a private remedy is essential to supplement the enforcement scheme of that section,[99] and (4) since federal courts have exclusive jurisdiction

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opening the federal courts to extensive litigation. 30 VAND. L. REV. 905, 920 (1977).

93. [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. April 21, 1978).

94. *See* note 46 *supra.*

95. 15 U.S.C. § 78q (1976). In 1972, the date relevant to *Redington,* this section provided in part:

> (a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 780 of this title, shall make, keep, and preserve for such period, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary and appropriate in the public interest or for the protection of investors. Such accounts . . . shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

96. SIPC sought to recover $14 million, either as subrogee of the broker's customers or as a member of a group directly injured by defendant. The trustee claimed damages of $51 million, either on behalf of the broker's customers or on behalf of the broker. The court ruled that SIPC could not sue in its own right, since its interests were not protected under section 17, but that it could sue as subrogee of the customers. The trustee's action on behalf of the broker was deemed barred by *Chris-Craft* and *Lank,* since the broker was precisely the entity sought to be regulated. The court held, however, that such considerations did not prevent the trustee's action as bailee of the customers' property. [Current] FED. SEC. L. REP. (CCH), at 93,435-36.

97. *Id.* at 93,433. The legislative history, however, reveals no desire on the part of Congress to create a legal obligation for accountants under § 17 of the Act. *See* 28 VAND. L. REV. 269, 277 n.52 (1975).

98. [Current] FED. SEC. L. REP. (CCH), at 93,434. The court reaffirmed its rule in *Abrahamson* that exclusive enforcement by the SEC will not be readily implied. *Id.; see* note 88 *supra.*

99. The court noted the usefulness of the SEC amicus brief insofar as it indicated that the SEC lacks the resources to audit all the reports filed pursuant to § 17 and consequently

over the Act, a private remedy would not be one traditionally relegated to state law. Having thus determined that the remedy sought satisfied the *Ash* criteria for implication of a private right of action the court next considered whether section 18[100] of the 1934 Act and the *Blue Chip* doctrine[101] barred plaintiffs' claim. Section 18 creates a private remedy for misleading statements in any report or document filed pursuant to the Act for any person who purchases or sells a security at a price affected by the misleading statement. The court observed that any misstatement in a section 17 broker's report would not affect the price of shares, and that a strict application of section 18 would therefore leave brokers' customers without remedy. Reasoning that Congress could not have intended such a result, the court found that section 18 did not provide the exclusive remedy for section 17 violations. Furthermore, the court held the purchaser or seller requirement inapplicable to customers. Thus brokers' customers were held to have a right of action against accountants for certifications that violate the standard set by section 17 and rule 17a-5.[102] Although the opinion is troublesome because it fails to address the obvious trend in recent Supreme Court decisions[103] toward restricting the scope of implied rights of action, it is nonetheless important as the first decision to imply a private right of action for damages under section 17.

IV. Analysis of the Implied Remedy Under Section 17

A. *Justification for an Implied Private Right of Action Under Section 17*

In view of the rule announced in *Amtrak*,[104] the initial question raised by the implication of a private remedy under section 17 is whether section 18 provides the exclusive remedy for section 17 violations.[105] The *Redington* court answered in the negative, pointing out that brokers' customers could never meet the requirements

must accept the vast majority of the audits at face value. [Current] Fed. Sec. L. Rep. (CCH), at 93,434 n.12.

100. 15 U.S.C. § 78r (1976).

101. *See* text accompanying note 67 *supra*.

102. [Current] Fed. Sec. L. Rep. (CCH), at 93,435.

103. The court cursorily dismissed the holdings in *Barbour*, *Ash*, and *Amtrak* on the ground that in those cases, intent to commit exclusive enforcement to public agencies was either implicit or explicit in the statutes. *Id.* at 93,434.

104. The existence of an express remedy under a statute creates a presumption against implying additional remedies. *See* text accompanying note 30 *supra*.

105. The district court answered this question affirmatively and thus concluded that no private remedy could be implied from section 17. Redington v. Touche Ross & Co., 428 F. Supp. 483 (S.D.N.Y. 1977).

of that section because they cannot qualify as purchasers or sellers and because misstatements in section 17 reports cannot influence the prices of securities invested for the customers. This analysis is correct assuming that one of the purposes of section 17 is to protect brokers' customers. Although section 17 appears prophylactic and regulatory in nature, it should be construed as directed toward customers' protection. Otherwise, the section's requirement that the SEC examine reports only "as necessary or appropriate in the public interest, or for the protection of investors" is meaningless.[106] Furthermore, once section 17 fails in its prophylactic purpose, as it did in *Redington,* it must become remedial in order to achieve its regulatory goals.[107] Thus, because section 18 does not provide the protection to brokers' customers intended by section 17, it should not be construed to limit the scope of the section 17 remedy.

Although the court's application of the *Ash* factors fails to adequately discuss and distinguish[108] recent Supreme Court decisions that either refused to imply a private remedy[109] or severely restricted the scope of recognized implied actions,[110] it nonetheless follows an appropriate approach to implication analysis and reaches the correct result. As in *Abrahamson,* the Second Circuit properly separated the question of implying a private remedy from the task of defining the elements of a cause of action under the remedy. Implication of a private remedy under section 17 is justifiable on several broad policy grounds. The rules promulgated by the SEC pursuant to section 17 require that brokers retain accountants to audit and certify their financial statements, and notify their customers in the event of "material inadequacies."[111] The SEC has asserted that the certification requirements "constituted a valuable regulatory tool for the protection of a customer" of a broker-dealer.[112] Similarly, the purpose behind the SIPA has been to afford protection to customers in the event their brokers encounter financial difficulties.[113] In light of these considerations as well as the fact that the SEC must

106. *See* note 95 *supra.*

107. The Supreme Court has consistently viewed the securities laws in general as fundamentally remedial in nature. *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

108. The court did not discuss previous applications of the *Ash* test.

109. *See* text accompanying notes 25-35 *supra.*

110. *See* text accompanying note 79 *supra.*

111. 17 C.F.R. § 240.17a-5 (1977).

112. SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H. R. Doc. No. 231, 92d Cong., 2d Sess. 24 (1971).

113. *See, e.g.,* Lohf v. Casey, 466 F.2d 618 (10th Cir. 1972); SEC v. Alan F. Hughes, Inc., 461 F.2d 974 (2d Cir. 1972).

rely on the audits supplied by independent accountants,[114] the creation of a private remedy with the concomitant liability imposed on accountants provides a useful deterrent to false or misleading certification and thus furthers the regulatory purpose of section 17. Furthermore, an implied private remedy forms a necessary supplement to enforcement by the SEC in order to eliminate the evils sought to be prevented by section 17.

B. *Scope of the Section 17 Remedy*

The impact of the *Redington* decision is unclear, primarily because the court did not set forth an appropriate standard for accountant liability under section 17 actions,[115] and did not formulate parameters for standing or for the elements of the cause of action recognized. In light of the Supreme Court's demonstrated intention to curtail the scope of implied remedies,[116] the new section 17 remedy seems to be clearly restricted to situations highly similar to that in *Redington*. Furthermore, in order to avoid the purchaser or seller standing requirement of *Blue Chip* and the problem of vexatious litigation and strike suits,[117] section 17 relief should be available only upon a showing of actual damages. This in turn means that the plaintiff class will be restricted to customers of failed brokerage firms, who can demonstrate a breach of duty on the part of the auditors. The explicit holding in *Barbour* precludes customers of brokers in financial difficulties from attempting to compel the SIPC to act on their behalf. Similarly, customers will be foreclosed from seeking injunctive relief against failing brokers absent a showing of irreparable harm.[118] In addition, although the holding in *Hochfelder* is based on statutory construction of section 10(b) and rule 10b-5, an allegation of scienter will probably be required in an action against accountants under section 17, especially since the duty of accountants under section 10(b) in *Hochfelder* was based on an interpretation of rules promulgated under section 17.[119] Such a requirement is desirable because it will tend to discourage speculative actions and to protect accountants[120] from incurring potentially de-

114. *See* note 99 *supra* and accompanying text.

115. The court remanded this question to the district court. [Current] FED. SEC. L. REP. (CCH), at 93,436.

116. *See* text accompanying note 79 *supra*.

117. *See* text accompanying note 69 *supra*.

118. *See* notes 62-65 *supra* and accompanying text.

119. *See* note 55 *supra*.

120. For a discussion of the role of accountants under the securities laws, see Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach*, 28 VAND. L. REV. 19 (1975).

structive penalties.[121] Finally, since the primary responsibility for protecting brokers' customers lies with the SIPC, the scope of the private remedy under section 17 should be narrowly construed to limit the federal courts' role as an additional arm of the Securities and Exchange Commission. These restrictions on the scope of a section 17 private right of action would have the desirable effect of allowing a remedy for a wrongful injury, without the multiple problems presented by regulation by the judiciary.

V. CONCLUSION

The approach adopted by the Second Circuit should provide a useful framework for other federal courts confronted with the issue of whether a statute implies a private cause of action, as private litigants search for alternative forms of relief following the curtailment of the scope of traditional implied remedies. While the section 17 right of action is apparently limited to a relatively small class of potential litigants, the structured and vigorous application of the *Ash* implication doctrine suggested by the Second Circuit exemplifies the approach that should be applied to other provisions of the securities laws. When confronted with claims for relief under these statutes, federal courts should strive to develop this type of rigorous analytical framework, clearly distinguishing the three major issues normally present—whether a right of action may be implied under the statute, whether plaintiffs have standing to assert a claim under the statute, and whether their claim is consistent with the right of action implied. Until Congress enacts clearly articulated standards for private remedies under the securities statutes, this analytical approach will assist courts in evaluating implication claims and will also provide guidance to private litigants considering instituting such actions.

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121. *See* note 96 *supra.*