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# Section 17(a) of the '33 Act: Defining the Scope of Antifraud Protection

# NOTES

## SECTION 17(a) OF THE '33 ACT: DEFINING THE SCOPE OF ANTIFRAUD PROTECTION

### A. *United States v. Naftalin*

Congress enacted the federal securities laws[1] to protect the public against fraudulent practices in the securities markets.[2] Several sections of these laws expressly permit private enforcement.[3] Some sections, however, allow the Securities and Exchange Commission (SEC) and defrauded investors to prosecute securities violations thereunder.[4] Additionally, certain sections of federal securities laws require proof of scienter to establish a violation,[5] while some provisions proscribe merely negligent conduct.[6] Section 17(a) of the Securities Act of 1933 ('33 Act)[7] neither

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[1] *See, e.g.*, the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976) ('33 Act); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1976)('34 Act); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z (1976); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 52 (1976); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 21 (1976) (Advisors Act).

[2] *See, e.g.*, H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940); H.R. REP. No. 1388, 73d Cong., 2d Sess. 2 (1934); H.R. REP. No. 85, 73d Cong., 1st Sess. 1-5 (1933); S. REP. No. 1775, 76th Cong., 2d Sess. 2 (1940); S. REP. No. 792, 73d Cong, 2d Sess. 1-5 (1934). Courts and commentators agree that the various federal securities laws attempt to protect investors from fraud by promoting high standards of business ethics in the securities industry. *See, e.g.*, Transamerica Mortg. Advisers, Inc. v. Lewis, 444 U.S. 11, 14-15 (1979) (Advisers Act protects investors from fraud in investment advisers industry); *accord*, Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1240 (5th Cir. 1978); United States v. Naftalin, 441 U.S. 768, 772 (1979) (purpose of '33 Act to protect investors and securities market operations from fraud); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ('34 Act prohibits fraudulent practices in securities industry to protect investors). *See generally*, Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933) [hereinafter cited as Douglas & Bates]; Landis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959) [hereinafter cited as Landis].

[3] *See, e.g.*, 15 U.S.C. §§ 77k, 77l, 77o (1976); 15 U.S.C. §§ 78i, 78p, 78r, 78t (1976).

[4] *See, e.g.*, 15 U.S.C. §§ 78j, 78n(a) (1976); 15 U.S.C. § 80b-15 (1976).

[5] *See, e.g.*, 15 U.S.C. §§ 78i(e), 78r(a), 78t (1976); 15 U.S.C. § 80b-6 (1976).

[6] *See, e.g.*, 15 U.S.C. § 77k(b)(3)(B) (1976) (§ 11(b)(3) (B) of '33 Act establishes negligence standard for liability of experts for misleading statements in registration statement); 15 U.S.C. § 77l (2) (1976) (§ 12(2) of '33 Act embodies negligence standard for misstatements and omissions). *Cf.* 15 U.S.C. § 77k(a) (1976) (§ 11(a) of '33 Act establishes liability without fault for misstatements in registration statement).

[7] 15 U.S.C. § 77q(a) (1976). Section 17(a) of the '33 Act states:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
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> (1) to employ any device, scheme, or artifice to defraud, or

explicitly confers a private right of action nor states the requisite degree of culpability necessary to recover if implied private rights exist under section 17(a).[8] Nevertheless, recent Supreme Court cases illustrate judicial expansion of the government's ability to enforce antifraud provisions by broadening the scope of section 17(a) and limiting private rights of action under the '33 Act.[9]

The '33 Act[10] regulates distribution of securities and seeks to protect the investing public against securities fraud.[11] In order to enforce these objectives, section 17(a) of the '33 Act generally prohibits fraud and misrepresentation in the offer or sale of securities.[12] Antifraud protection under section 17(a), however, does not specifically extend to persons acting as agents for purchasers. The Supreme Court, in *United States v. Naftalin*,[13] recently examined whether section 17(a) protects agents engaged in ordinary market trading for investors against fraudulent schemes.

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(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

*Id.*

[8] *See* note 7 *supra.*

[9] *See* text accompanying notes 24-52 and 83-94 *infra.*

[10] 15 U.S.C. §§ 77a-77aa (1976).

[11] *See* Kaplan, *Statutory Framework of the Securities Act of 1933 and the Securities Exchange Act of 1934*, INTRODUCTION TO SECURITIES REGULATION 13 (PLI 1979); Note, *Scienter and SEC Injunctive Actions Under Securities Act Section 17(a)*, 63 IOWA L. REV. 1248, 1260 (1978) [hereinafter cited as *Scienter and Section 17(a)*]. The '33 Act was the first comprehensive federal regulatory scheme for the distribution of securities. *See generally* Douglas & Bates, *supra* note 2; *see also* Landis, *supra* note 2. Distribution is the process by which securities are transferred from the issuer to the investing public. Primary distribution occurs by issuing the securities by a direct placement or through an underwriter. *See* 15 U.S.C. §§ 77b(4), 77b(11) (1976) (respective definitions of "issuer" and "underwriter"). A secondary offering is a two-step process whereby an investor who has acquired a substantial block of securities from the issuer sells the securities to another investor. *See, e.g.*, United States v. Wolfson, 405 F.2d 779 (2d Cir.), *cert. denied*, 394 U.S. 946 (1968); *In re* Ira Haupt & Co., 23 S.E.C. 589 (1946). In contrast to distribution, securities trading encompasses securities transactions on the open market effected through a broker, on an exchange, or otherwise. *See* 15 U.S.C. § 78k (1976). Although the '34 Act originally was geared to national securities exchanges, Congress amended the '34 Act to cover over-the-counter markets as well. Securities Acts Amendments of 1964, 15 U.S.C. § 78l (g) (1976).

Concommitant with regulating the distribution process, the '33 Act seeks to assure the availability of adequate reliable information about securities offerings by requiring registration of the securities. 15 U.S.C. § 77e (1976). Certain securities and transactions are exempt from the registration requirement. *See* 15 U.S.C. §§ 77c, 77d (1976). A registration statement, filed with the Securities and Exchange Commission (SEC), contains certain required information sufficient to enable a potential investor to make an informed assessment of a security prior to purchase. 15 U.S.C. § 77g (1976).

[12] 15 U.S.C. § 77q(a) (1976).

[13] 441 U.S. 768 (1979).

*Naftalin* arose as a result of a criminal prosecution involving a violation of section 17(a)(1) of the '33 Act.[14] Naftalin, the president of a broker-dealer firm, engaged in a fraudulent short-selling scheme by falsely representing that he owned the stocks he wished to sell.[15] Naftalin selected several securities that, in his estimation, had peaked in price and were about to decline.[16] Under the pretense of owning the stocks, Naftalin placed sell orders with five brokers, intending to make off-setting stock purchases at lower prices.[17] The market price rose sharply, however, preventing Naftalin from making delivery and forcing the brokers to buy replacement shares at a higher price.[18]

The Department of Justice indicted Naftalin on eight counts of securities fraud under section 17(a).[19] At trial, the district court imposed criminal liability on Naftalin pursuant to section 24 for willfully employing a scheme and artifice to defraud in the sale of securities in violation of section 17(a)(1).[20] On appeal, the Eighth Circuit reversed the conviction despite finding that Naftalin had engaged in a fraudulent scheme.[21] The court held that the government must prove some impact of the scheme on investors, as opposed to agent-brokers, to establish a section 17(a)(1) violation.[22] The court reasoned that the purpose of the '33 Act was limited to

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[14] Section 24 of the '33 Act provides criminal sanctions for willful violations of any provision of the '33 Act or of any rules or regulations promulgated by the SEC therein. 15 U.S.C. § 77x (1976).

[15] 441 U.S. at 770. Shortselling is a device whereby an investor sells stock he does not own in anticipation of a decline in that stock's market price. The speculator hopes to make delivery by purchasing the stock at the lower price, thereby realizing as profit the difference between the sales price and the lesser purchase price. *See* SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. No. 1455, 73d Cong., 2d Sess. 50-51 (1934); 17 C.F.R. § 240.3b-3 (1979) (definition of "short-sale"). *See generally* 2 L. LOSS, SECURITIES REGULATION 1224-35 (2d ed. 1961) [hereinafter cited as Loss]. Short selling is lawful unless made in contravention of SEC rules. *See* 15 U.S.C. § 78j (1976); 17 C.F.R. § 240.10a-1 (1979). The SEC requires brokers and dealers to mark all sell orders either "short" or "long" prior to trading. 17 C.F.R. § 240.10a-1(c) (1979). In order to mark a sell order "long," a broker-dealer must be informed that the security to be delivered after sale is carried in the account for which the sale is to be effected and that the seller owns the security and will deliver the security as soon as possible. 17 C.F.R. § 240.10a-1(d) (1979); *see* note 17 *infra*.

[16] 441 U.S. at 770.

[17] *Id.* By lying about his ownership of the securities, Naftalin fraudulently induced the five brokers to mark the sell orders "long." *Id.; see* note 15 *supra*. Naftalin was familiar with securities trading and knew that, had he been truthful, the brokers would have rejected his sell orders or required a margin deposit. *Id.*

[18] *Id.* Execution of a sell order marked "long" incurs potential liability on behalf of a broker because he must assure delivery of the securities. If the seller fails to deliver the securities when due, the broker must "buy-in" substitute shares for the purchasers under some circumstances. *See* 17 C.F.R. § 240.10a-2(a) (1979); text accompanying notes 38-41 *infra*.

[19] *See* United States v. Naftalin, 579 F.2d 444, 445 (8th Cir. 1978); notes 14 & 18 *supra*.

[20] 579 F.2d at 445.

[21] *Id.* at 447.

[22] *Id.* The Eighth Circuit observed that *Naftalin* might be the first case that the government prosecuted solely under § 17(a)(1) in which the principal fraud was perpetrated

protecting investors from fraudulent securities practices. The Supreme Court, reversing the Eighth Circuit, held that section 17(a) prohibits frauds against brokers and investors in an offer or sale of securities effected in the distribution process or in ordinary market trading.[23]

The Supreme Court first addressed the threshold question whether section 17(a) applies to frauds occurring in the aftermarket.[24] Naftalin contended that the '33 Act regulates only initial offerings.[25] Since the fraudulent short sales did not involve a new offering, Naftalin argued that the Court could not apply section 17(a) to his case.[26] Rejecting Naftalin's claim, the Court stated for the first time that, despite the '33 Act's regulation of public distributions and initial offerings, section 17(a) prohibits fraudulent practices in offers and sales without regard to the particular phase of the selling transaction.[27] The *Naftalin* Court observed that the language of section 17(a) makes no distinction between transactions in public distributions or in aftermarket trading.[28] In addition, the Court's examination of the legislative history of the Act demonstrated that Congress intended section 17(a) to be a major departure from the '33 Act's primary concern with public distributions.[29] The Supreme Court concluded that section 17(a) protects the investing public from fraud in the offer or sale of new and old outstanding stock issues.[30]

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upon brokers rather than investors. *Id.* at 448. Although § 10(b) of the '34 Act also prohibits fraudulent schemes, *see* note 30 *infra*, the government declined to prosecute under § 10(b). The scope of § 10(b) clearly covers frauds against investors. *See* A. T. Brod & Co. v. Perlow, 375 F.2d 393, 396 (2d Cir. 1967) (stockbroker civil action for damages against investor upheld under § 10(b) and Rule 10b-5). In civil and criminal proceedings, § 10(b) applies to fraudulent short-selling schemes, regardless of any effect on the investor. *See* United States v. Peltz, 433 F.2d 48, 53 (2d Cir.), *cert. denied*, 401 U.S. 955 (1971).

[23] 441 U.S. at 771-72.

[24] 441 U.S. at 777-78. Aftermarket trading refers to ordinary market trading of a security after the public offering of a security. *See* note 11 *supra*.

[25] 441 U.S. at 777-78. Several legal commentators interpret the scope of § 17(a) as limited to frauds occurring solely in the initial distribution of securities. *See, e.g.*, Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641, 645 & 657-58 (1978) [hereinafter cited as Hazen]; Landis, *supra* note 2, at 46; Note, *Nonpurchaser Plaintiff Given Standing To Bring An Action Under Section 17(a) of the Securities Act of 1933: Another Threat To the* Birnbaum *Doctrine*, 51 TEMP. L.Q. 912, 921-22 (1978).

[26] 441 U.S. at 777-78. Naftalin, admitting his guilt, contended that prosecution under § 17(a) was improper. *Id.* at 772. Naftalin's fraudulent scheme clearly violates the specific short-selling regulations under the '34 Act, *see* 15 U.S.C. §§ 78g, 78j(a) (1976); 12 C.F.R. §§ 220.3, 220.4(c)(ii), 220.8(d), 224.2 (1979); 17 C.F.R. § 240.10a-1 (1979), and the '34 Act's general antifraud proscriptions, 15 U.S.C. § 78j(b) (1976), 17 C.F.R. § 240.10b-5 (1979).

[27] 441 U.S. at 771-74.

[28] 441 U.S. at 777-78; *see* 15 U.S.C. § 77q(a) (1976); note 12 *supra*.

[29] 441 U.S. at 777-78; *see* 1 LOSS, *supra* note 15, at 130; Douglas & Bates, *supra* note 2, at 182; V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 740 (1972). The Senate Report reveals that the '33 Act "subjects the sale of old . . . securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues. . . ." S. REP. NO. 47, 73d Cong., 1st Sess. 4 (1933).

[30] 441 U.S. at 777-78; *see* note 29 *supra*.

Having determined the applicability of section 17(a) to the *Naftalin* case, the Court turned to Naftalin's assertion that section 17(a)(1) applies solely to frauds directed against investor-purchasers.[31] The Court refuted Naftalin's claim by analyzing the language of section 17(a)(1) and the legislative history behind the '33 Act.[32] The Supreme Court observed that nothing on the face of the statute requires a plaintiff to reach investor status in order to avail himself of section 17(a) remedies.[33] Furthermore, the Court determined that each subsection of section 17(a) proscribes a distinct category of misconduct.[34] The language "upon the purchaser" found in section 17(a)(3) is, therefore, inapplicable to subsection (a)(1).[35] The *Naftalin* Court also considered whether the language of section 17(a) requires that fraud occur in a particular phase of the selling transaction.[36] Interpreting "offer" and "sale," the Court concluded that the scope of section 17(a) encompasses transactions in all phases of the selling process, including broker-customer dealings.[37] The Supreme Court substantiated its readings of the statute by comparing the "in the offer or sale" language of section 17(a) to the "in connection with" language found in section 10(b) of the Securities Exchange Act of 1934 ('34 Act).[38] Recognizing

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[31] 441 U.S. at 771.

[32] *Id.* at 771-74.

[33] *Id.* at 772; *see* note 7 *supra.*

[34] 441 U.S. at 773-74. Naftalin contended that the phrase "upon the purchaser" found in § 17(a)(3), *see* note 4 *supra,* applies to all three subsections. The Supreme Court flatly rejected this contention based upon the language and structure of the statute. The Court observed that the phrase "upon the purchaser" is a part of subsection (3) alone. *Id.* Furthermore, the use of an infinitive and separate numbers to introduce each subsection create distinct categories of proscribed conduct. *Id.* at 774 n.5. Recognizing that structure and punctuation alone do not decide the meaning of a statute, *id., see* Costanzo v. Tillinghast, 287 U.S. 341, 344 (1932), the Supreme Court emphasized that the composition of § 17(a) confirmed the conclusion that each successive prohibition covers additional types of illegal conduct. 441 U.S. at 773-74; *see* Steinberg, *Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GEO. L.J. 163, 168 (1979) [hereinafter cited as Steinberg].

[35] 441 U.S. at 773-74.

[36] *Id.* at 772-73.

[37] *Id.* Section 2(3) of the '33 Act provides that "[t]he term 'sale' . . . shall include every contract of sale or disposition of a security, or interest in a security, for value. The term . . . 'offer' shall include every attempt or offer to dispose of . . . a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1976).

Congress expressly intended to define the terms "offer" and "sale" broadly in order to advance the regulatory purpose of the '33 Act and its antifraud provisions. *Id.; see* 441 U.S. at 772-73; H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933); 1 LOSS, *supra* note 15, at 512 n.163.

[38] 15 U.S.C. §§ 78a-78hh (1976). Section 10(b) of the '34 Act, 15 U.S.C. § 78j(b) (1976), prohibits the use or employment of any manipulative or deceptive device or contrivance in the offer or sale of any security. *Id.* Naftalin asserted that the difference between "in" and "in connection with" constitutes a significant distinction between the scope of § 17(a) and § 10(b). 441 U.S. at 772 n.4. Therefore, Naftalin contended that "in the offer or sale of securities" under § 17(a) connotes a narrower range of activities than the language of § 10(b). *Id.* The linguistic discrepancy between the two sections prompted the government to allow that the phrase "in connection with" may indicate a looser relationship to the securities industry than the term "in." Brief for the United States at 15 n.12, United States v. Naftalin, 441

that the Court and Congress frequently use these terms interchangeably, the *Naftalin* Court refused to interpret "in" as encompassing more limited activities than "in connection with" the offer or sale of securities.[39] Since Naftalin's sell orders resulted in sales, the Court held that the fraudulent scheme violated section 17(a)(1) of the '33 Act.[40]

In support of a broad interpretation of section 17(a), the Supreme Court examined the legislative history of the '33 Act to determine that Act's purpose and scope.[41] Rejecting the Eighth Circuit's restrictive interpretation of the Act's purpose,[42] the Court maintained that Congress intended not only to protect investors but also to enforce ethical business practices throughout the securities industry.[43] Additionally, the Court emphasized that the interests of investors and financial intermediaries are interrelated.[44] Frauds against either group may ultimately injure the other as well as the national economy.[45] As a result of the brokers' obligation to buy substitute stocks, the *Naftalin* investors suffered no direct financial injury.[46] The Court recognized, however, that frauds perpetrated against brokers may have substantial indirect effects on investors.[47] In view of the possible harm that fraudulent schemes can cause, the Su-

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U.S. at 768.

[39] 441 U.S. at 772 n.4. The Supreme Court acknowledged using the terms "in" and "in connection with" interchangeably prior to *Naftalin*. *Id.*, *see* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971). The Court recognized similar interchangeable use on the part of Congress. 441 U.S. at 772 n.4; *see* H.R. REP. No. 85, 73d Cong., 1st Sess. 6 (1933). The "in" language of § 17(a) may now cover as broad a range of transactions as the "in connection with" language of § 10(b) of the '34 Act. *See* Steinberg, *supra* note 34, at 171.

[40] 441 U.S. at 771.

[41] *Id.* at 774-78.

[42] *Id.* at 774-77. The Eighth Circuit determined that Congress enacted the '33 Act to protect investors from fraudulent practices in the sale of securities. 579 F.2d 444, 447 (8th Cir. 1978). Thus, interpreting the scope of the Act narrowly, the Eighth Circuit concluded that § 17(a) antifraud protection extended only to investors. *Id.* at 448; *see* text accompanying note 22 *supra*.

[43] 441 U.S. at 775; *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ('33 and '34 Acts protect investors from fraud and promote ethical business standards); *accord*, SEC v. Capital Gains Bureau, 375 U.S. 180, 186-87 (1963).

[44] 441 U.S. at 776-77. The Court recognized that frauds perpetrated against brokers have an indirect impact on investors. *Id.; see* text accompanying note 4 *supra*.

[45] 441 U.S. at 776-77; *see* note 18 *supra*.

[46] 441 U.S. at 776-77.

[47] *Id.* Losses suffered by brokers increase operational costs. Investors bear the burden of increased costs through higher brokerage fees. *Id.* Furthermore, unchecked fraudulent short sales through brokers operate to the detriment of investors and the economy by artificially increasing the uncertainty of the securities market. The investors in *Naftalin* suffered no immediate financial injury because the brokers were able to "buy in." *See* text accompanying note 18 *supra*. If brokers are not able to buy in, however, investors fail to receive anticipated shares or must pay a higher price for substitute shares. 441 U.S. at 776-77. Indirect injury to investors remains possible despite reduction of the potential for direct losses under "buy in" regulations. *See* 17 C.F.R. § 240.10a-2 (1978). *See generally* Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1976).

preme Court concluded that section 17(a) of the '33 Act protects individual investors and the sanctity of market mechanisms.[48]

The *Naftalin* decision significantly expands the class of persons entitled to receive antifraud protection. According to the statutory construction of the *Naftalin* Court, the protections afforded by subsections (1) and (2) of section 17(a) are not restricted to actual purchasers or investors.[49] Financial intermediaries form an integral part of the operation of the securities market and, therefore, rightfully deserve SEC protection from fraudulent conduct.[50] Had the Supreme Court held otherwise, brokers would bear all losses caused by frauds not affecting investors. The *Naftalin* Court, however, refused to create a loophole in the Act for dishonest conduct by excluding brokers from the antifraud protection of section 17(a). Although narrowing the reach of section 17(a) would have been in accordance with recent restrictions on civil remedies under federal securities laws,[51] the Court chose to widen the scope of section 17(a) to include aftermarket frauds.[52] Clearly, the *Naftalin* Court is expanding the antifraud protection under section 17(a) to facilitate government enforcement of the purpose of the '33 Act.

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[48] 441 U.S. at 771-77.

[49] *See* text accompanying notes 23-34 *supra*.

[50] 441 U.S. at 776-77; *see* Steinberg, *supra* note 34, at 170.

[51] *See, e.g.*, Transamerica Mortg. Advisers, Inc. v. Lewis, 444 U.S. 11, 21 (1979) (limited private remedy implied only under § 215 of Advisers Act); Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979) (no implied private right of action for damages under § 17(a) of the '34 Act); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 563 (1979) (interest in noncontributory, compulsory pension plan not "security," and thus not subject to regulation under Securities Acts); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977) (breach of fiduciary duty, without fraud, deception or misrepresentation not actionable under § 10(b) of the '34 Act and Rule 10b-5); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 37-41 (1977) (defeated tender offeror has no standing to bring implied private right of action for damages under § 14(e) of the '34 Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (scienter required in private damage actions under § 10(b) and Rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (only purchasers and sellers have standing to bring implied private cause of action for damages under § 10(b) and Rule 10b-5). *See generally*, Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977) [hereinafter cited as Lowenfels].

[52] 441 U.S. at 771-74. The *Naftalin* Court's decision to extend antifraud protection to brokers is not without precedent. *See* United States v. Brown, 555 F.2d 336, 338-39 (2d Cir. 1977). In *Brown*, the court indicated that the criminal provisions of § 17(a) of the '33 Act apply even when the ultimate purchaser of securities has not been injured or defrauded. *Id.* Unlike *Naftalin*, however, *Brown* involved a scheme that defrauded investors as well as brokers. Prior to *Brown*, the Second Circuit extended the reach of § 17(a) to protect defrauded bond lenders. United States v. Gentile, 530 F.2d 461, 467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). Significantly, both *Brown* and *Gentile* involved transactions in aftermarket trading, instead of offers or sales in the course of an initial distribution. 555 F.2d at 338-39; 530 F.2d at 464; *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). In *Hochfelder*, the Court asserted that Congress enacted the '33 Act to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud, and to promote high ethical standards of honesty and fair dealing. *Id.* Including brokers within the auspices of § 17(a) is, therefore, consistent with the Supreme Court's earlier interpretation of the regulatory scheme embodied by the '33 Act.

### B. *Implied Private Rights of Action Under Section 17(a)*

Although courts recognize implied private rights of action under certain sections of the federal securities laws,[53] the Supreme Court recently has been reluctant to extend relief to private parties under securities statutes.[54] In recent years, the Court has tightened standing requirements under securities statutes that afford private causes of action, thereby limiting the class of private parties eligible for relief.[55] Section 17(a) of the '33 Act, however, does not expressly confer a private right of action upon defrauded investors.[56] Court decisions are presently in conflict over whether section 17(a) embodies private rights of action.[57] The Supreme Court decision in *Transamerica Mortgage Advisers, Inc. v. Lewis*,[58] however, signals an end to the controversy over private rights under section 17(a).[59] Evincing a conservative attitude towards implication issues, the *Transamerica* Court restricted and modified the once-definitive standard announced in *Cort v. Ash*[60] for determining whether implied private

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[53] *See* note 3 *supra*.

[54] *See generally* Lowenfels, *supra* note 51; *1978-1979 Securities Law Developments*, 36 WASH. & LEE L. REV. 757, 859-67 (1979) [hereinafter cited as *1978-1979 Securities Developments*].

[55] *See* note 51 *supra*.

[56] *See* note 7 *supra*.

[57] Several courts have expressly or impliedly recognized private rights of action under § 17(a). *See, e.g.*, Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040 n.2 (7th Cir. 1979); Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978); Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1280 n.2 (2d Cir. 1973); Kellman v. ICS, Inc., 447 F.2d 1305, 1308 (6th Cir. 1971). These courts, however, imply private rights based upon a parallel implied remedy under § 10(b) and Rule 10b-5 of the '34 Act, rather than statutory construction. Many of these courts maintain that there is little practical point in denying private rights under § 17(a) since private rights exist under § 10(b) and Rule 10b-5. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring). Few courts that support implication apply the test suggested by Cort v. Ash, 422 U.S. 66 (1975). *See, e.g.*, Demoe v. Dean Witter & Co., 476 F. Supp. 275, 278-81 (D. Alaska 1979); note 61 *infra*. Courts that deny private rights under § 17(a) examine the language, legislative history and purpose of § 17(a). *See, e.g.*, Gunter v. Hutcheson, 433 F. Supp. 42, 45 (N.D. Ga. 1977); Reid v. Mann, 381 F. Supp. 525, 526-28 (N.D. Ill. 1974); Hardy v. Sanson, 356 F. Supp. 1034, 1038 (N.D. Ga. 1973); Dyer v. Eastern Trust and Banking Co., 336 F. Supp. 890, 903-05 (D. Me. 1971); *see* text accompanying notes 62-65 *infra*. Some courts recognize implied rights only under §§ 17(a)(1) and (3), *see* Wulc v. Gulf & Western Indus., Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1095 (E.D. Pa. 1972), while other courts recognize private rights under § 17(a)(2) only if the plaintiff meets the requirements of § 12(2) of the '33 Act, *see* Greater Iowa Corp. v. McLendon, 378 F.2d 783, 790 (8th Cir. 1967); *In re* Falstaff Brewing Corp. Antitrust Litigation, 441 F. Supp. 62, 67 (E.D. Mo. 1977).

[58] 444 U.S. 11 (1979).

[59] *See* text accompanying notes 95-138 *infra*.

[60] 422 U.S. 66 (1975). In *Cort*, the Supreme Court faced the issue whether a private party could sue an alleged violator of the Federal Election Campaign Act (FECA). *Id.* at 70-71. The FECA prohibits corporations from making contributions to federal elections. *See* 2 U.S.C. § 441b (1976). The plaintiff brought suit against Bethlehem Steel Corp. and its directors for financially supporting political advertisements in the 1972 presidential election. Despite the absence of an express private remedy, the plaintiff sought damages and injunctive

rights exist under a federal statute.[61]

The *Cort* decision created a four-prong implication test for courts to apply to statutes affording no private remedy.[62] The court, under the first prong, must ascertain whether the plaintiff is a member of the class that benefits specially from the protection offered by the statute.[63] According to the second *Cort* factor, the court must examine the legislative history of the statute to determine whether Congress explicitly or implicitly intended to create or to deny a private cause of action under the statute.[64] The third *Cort* inquiry requires the court to decide whether an implied private right is consistent with the underlying purpose of the legislative scheme.[65] Finally, the court must determine if the cause of action is one traditionally relegated to state law.[66]

In *Touche Ross & Co. v. Redington*,[67] the Supreme Court modified the *Cort* test and reaffirmed its restrictive posture toward implied private rights of action under federal securities laws.[68] The *Redington* Court ob-

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relief as a shareholder of Bethlehem. 422 U.S. at 70-72.

[61] *See* 444 U.S. 11, 15-24; text accompanying notes 84-94 *infra*. The Supreme Court employed the *Cort* test in several cases presenting the issue of implied rights under various federal statutes. *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 568-74 (1979) (*Cort* implication analysis applied to § 17 of '34 Act); Cannon v. University of Chicago, 441 U.S. 677, 689-709 (1979) (application of *Cort* implication test to title IX of Education Amendments to Civil Rights Act of 1964); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 34-41 (1977) (*Cort* implication test applied to § 44(e) of '34 Act).

In *Cannon*, the Supreme Court recognized private rights under Title IX. 441 U.S. at 689; *see* 20 U.S.C. §§ 1681-86 (1976). The Supreme Court denied private rights, however, in *Redington*, 442 U.S. 560, 577-79; *see* 15 U.S.C. § 78l (1976), and in *Piper*, 430 U.S. at 39; *see* 15 U.S.C. § 78n (1976). *Piper* was the first case in which the Supreme Court applied the *Cort* test to a federal security statute. *See 1978-1979 Securities Developments*, *supra* note 54, at 947-48. The *Redington* decision, however, did not apply the *Cort* test in its original form. *See* 442 U.S. at 757; text accompanying notes 67-74 *infra*.

[62] *See* 422 U.S. at 78. The Court delineated four issues relevant to a determination whether a federal statute creates an implied private right of action. *Id.; see* text accompanying notes 63-66 *infra*.

[63] 422 U.S. at 78; *see* Texas & Pacific Ry. Co. v. Rigsby, 241 U.S. 33, 39 (1916).

[64] 422 U.S. at 78; *see* National R.R. Pass. Corp. v. National Ass'n of R.R. Pass., 414 U.S. 453, 458 (1974).

[65] 422 U.S. at 78; *see* Securities Inv. Protection Corp. v. Barbour, 421 U.S. 412, 423 (1975); National R.R. Pass. Corp. v. National Ass'n of R.R. Pass., 414 U.S. 453, 458 (1974).

[66] 422 U.S. at 78.

[67] 442 U.S. at 560 (1979). *Redington* arose from the insolvency and liquidation of Weis Securities, Inc. *Id.* at 563-66. Plaintiff Redington brought suit as trustee in liquidation to recover damages on behalf of the Weis firm and its customers from the defendant accounting firm, Touche Ross. *Id.* at 565. Securities Investor Protection Corp. (SIPC) joined Redington in the action and asserted derivative claims as insurer of Weis' customers. *Id.* The plaintiffs alleged that Touche Ross prepared and certified false and misleading financial statements in violation of § 17(a) of the '34 Act. *Id.* at 565-66; *see* 15 U.S.C. § 78q (1976) (requiring accounting and administrative reports from securities brokers and dealers). The plaintiffs asserted that an implied private right of action exists under section 17(a) and demanded recovery of damages for these violations. *Id.* at 566; *see* Steinberg, *supra* note 34, at 173-75; *1978-1979 Securities Developments*, *supra* note 54, at 948-53.

[68] *See* 442 U.S. at 568-74; text accompanying notes 70-71 *infra*. The Supreme Court

served that examination of the language, legislative history, and purpose of a statute are the proper means for resolving the implication issue.[69] Since the first three criteria of the *Cort* standard are the traditional indicia of legislative intent, the *Redington* Court placed special emphasis on these factors.[70] If these three inquiries remain unsatisfied, the *Redington* Court held that courts need not determine whether an implied private right is a cause of action traditionally relegated to state law.[71] In denying private rights under section 17(a) of the '34 Act,[72] the Court indicated for the first time that the four elements of the *Cort* test do not deserve equal weight.[73] The *Redington* Court concluded that the central inquiry is whether Congress intended to create a private cause of action.[74]

The *Transamerica* Court narrowed the focus of the *Cort* implication analysis.[75] In *Transamerica,* plaintiff Lewis alleged that the defendants, in advising and managing the Mortgage Trust of America, committed frauds and breaches of fiduciary duties in violation of sections 206 and 215 of the Investment Advisers Act of 1940 (Advisers Act).[76] Section 215

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acknowledged that earlier implication cases adhered to an expansive remedial doctrine in favor of implied private rights. *Id.* at 578; *see, e.g.,* J.I. Case Co. v. Borak, 377 U.S. 426, 429-30 (1964). The *Redington* Court recognized that recent cases applied a stricter standard for the implication of private rights, *see, e.g.,* Cannon v. University of Chicago, 441 U.S. 677, 690-93 (1979); Securities Inv. Protection Corp. v. Barbour, 421 U.S. 412, 424 (1975), and expressly adopted this conservative approach. 442 U.S. at 577.

[69] *Id.* at 568-74. The *Redington* Court, in order to discern congressional purpose, examined the language of § 17 of the '34 Act in light of the first *Cort* factor. *Id.* at 568-71. The Court observed that the ultimate beneficiaries of § 17 are the investing public since § 17 failed to proscribe certain conduct or to confer federal rights on the plaintiff as a broker's customer. *Id.* at 570-71. Addressing the second *Cort* factor, the Court determined that the brief legislative history of § 17(a) did not support implication of a private right. *Id.* at 571 n.11. The *Redington* Court, in accordance with the third *Cort* element, examined the legislative scheme of the '34 Act. *Id.* at 571. The Court recognized that implied rights under § 17(a) were inconsistent with the framework of the '34 Act. *Id.* at 571-74. Since these criteria militated against implication, the *Redington* Court denied private rights under § 17(a) without further inquiry. *Id.* at 574.

[70] *Id.* The *Redington* Court observed that the judiciary should not imply a private remedy without adequate evidence of congressional intent to confer that private right. *Id.* To do otherwise, the Court reasoned, would infringe upon the legislative power of Congress. *Id.* at 577-79. The *Redington* Court invited Congress to provide a federal damage remedy under § 17(a). *Id.*

[71] *Id.* at 574. *Redington* emphasized that the implication issue is essentially a matter of statutory construction. *Id.* at 568. Accordingly, the *Redington* Court limited its inquiry to the language of § 17(a) and the congressional intent behind that section. *Id.* at 568-578. In the absence of congressional intent to provide a private right, *Redington* refused to consider the final *Cort* factor. *Id.* at 575-77.

[72] *Id.* at 575-78.

[73] *See id.* at 575-76; *1978-1979 Securities Developments, supra* note 54, at 950-953.

[74] 442 U.S. at 575-77; *see* note 70 *supra.*

[75] 444 U.S. at 23-24; *see* text accompanying notes 83-94 *infra.*

[76] 444 U.S. at 12-13. Lewis, a shareholder of Mortgage Trust of America (Trust), brought suit as a derivative action on behalf of the Trust and as a class action on behalf of the Trust's shareholders. *Id.* at 13. The defendants were the Trust, Transamerica Mortgage Advisers, Inc. (TAMA), several individual trustees and two affiliated corporations (Land

of the Advisers Act voids certain advisory contracts.[77] Section 206, however, simply proscribes certain conduct and establishes federal fiduciary duties of investment advisers.[78] Plaintiff Lewis asserted that an implied right of action exists under both sections,[79] and sought equitable relief from a void advisory contract and recovery of damages for violations of fiduciary obligations.[80] Adhering to the *Cort* analysis as modified by *Redington,*[81] the Supreme Court implied a private cause of action under section 215, but refused to accept the plaintiff's implication claim under section 206.[82]

The Supreme Court premised its analysis of the implication issues in *Transamerica* upon basic statutory construction.[83] Echoing *Redington,* the Court emphasized that the appropriate inquiry is whether Congress intended to create the private cause of action asserted.[84] Accordingly, the *Transamerica* Court selected the second *Cort* factor as the initial inquiry under its implication analysis.[85] The Court reorganized the second prong of the *Cort* test to include examination of statutory language and legislative history.[86] If neither language nor legislative sources reveal congres-

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Capital and Transamerica). *Id.* Plaintiff Lewis asserted three causes of action allegedly arising under the Advisers Act. *Id.* at 13-14; *see* 15 U.S.C. §§ 80b-1 to 21 (1976). The first cause of action stated that the advisory contract between Trust and TAMA was illegal. 444 U.S. at 13. Lewis maintained that Transamerica and TAMA were not registered under the Advisers Act and that the advisory contract provided for grossly excessive compensation. *Id.* The complaint's second allegation contended that the defendants breached fiduciary duties to the Trust by purchasing inferior securities on behalf of the Trust. *Id.* The third cause of action asserted that the defendants misappropriated lucrative investment opportunities for the benefit of other companies affiliated with Transamerica. *Id.* at 13-14.

[77] *See* 15 U.S.C. § 80b-6 (1976).

[78] *See* 15 U.S.C. § 80b-15 (1976).

[79] 444 U.S. at 13-15. The trial court ruled that the Advisers Act confers no private rights and dismissed the complaint. *Id.* at 14. Reversing the District Court, the Ninth Circuit held that implied private rights under the Advisers Act are necessary to achieve the congressional purpose of that legislation. Lewis v. Transamerica Corp., 575 F.2d 237, 239 (9th Cir. 1978).

[80] 444 U.S. at 14-15. The customary legal incidents of a void contract are avoidance of the contract and restitution of consideration paid. *See* Deckert v. Independence Shares Corp., 311 U.S. 282, 289 (1940); S. WILLISTON, CONTRACTS § 1525 (3d ed. 1957). Unless a statute expressly provides for monetary liability, however, a court must be wary of awarding damages. *See* 444 U.S. at 19.

[81] *See* text accompanying notes 68-74 *supra. But see* text accompanying notes 84-94 *infra* (modifying implication analysis premised on *Cort-Redington* test).

[82] 444 U.S. at 23-24.

[83] *Id.* at 16; *accord,* Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979).

[84] 444 U.S. at 16. The *Transamerica* Court recognized that earlier opinions emphasized the desirability of implying private remedies to effectuate the purpose of a certain statute. *Id.; see, e.g.,* J.I. Case Co. v. Borak, 377 U.S. 426, 429-30 (1964). Determination of congressional intent, however, is the ultimate inquiry under *Transamerica,* 444 U.S. at 15-16, and *Redington,* 442 U.S. at 568.

[85] *See* 444 U.S. at 15-17. The *Transamerica* Court neglected to use the "prong" terminology employed by courts that apply the traditional four-prong *Cort* analysis. *See id.* at 16-24.

[86] 444 U.S. at 16-22. Originally, the second *Cort* factor examined only the legislative

sional intent to imply a private right of action, the inquiry ends with a denial of private rights.[87] The *Transamerica* Court reasoned that when Congress wished to provide a private damage remedy, Congress could do so expressly.[88] Once the statute satisfies the initial level of the modified *Cort* test, a court must consider the third *Cort* factor to determine if the implication of a private right is consistent with the purpose of the statute.[89] *Transamerica* redefines the third *Cort* element as a two-pronged inquiry. This secondary level of the implication inquiry comprehends an identification of the special class that benefits from the statute and a determination whether implied private rights are necessary to fulfill the purpose of the entire legislative scheme.[90] Neither protection of a special class nor statutory purpose, however, necessitates implication of private rights without evidence of congressional directive to do so.[91] Since the foregoing factors proved determinative,[92] the *Transamerica* Court did not address the fourth *Cort* factor.[93] Determining whether an adequate state remedy exists, however, remains a part of the modified *Cort* test if the statute meets the preceding factors.[94] The *Transamerica* decision, there-

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history of a statute to determine whether Congress intended to provide a private remedy. *See* text accompanying note 64 *supra*. The *Cort-Transamerica* test, however, examines the express language and historical sources of a statute to ascertain congressional intent. 444 U.S. at 16-22.

[87] *Id.* at 23-24. The *Transamerica* Court reasoned that if the language and legislative history reflect negatively on the implication issue, the inquiry is at an end. *Id.* The Court examined the texts of §§ 206 and 215 and concluded that the language of § 215 fairly implies a private right of action for a void contract. *Id.* at 17-18. The language of § 206, however, simply proscribes certain conduct and does not create civil liabilities. *Id.* at 19. The Court recognized that the legislative history of the Advisers Act failed to consider private rights. *Id.* at 18. Congressional intent, the Court reasoned, may be implicit in the structure of the statute or the circumstances of its enactment. *Id.; see* Cannon v. University of Chicago, 441 U.S. 677, 694 (1977); note 89 *infra*.

[88] 444 U.S. at 23-24.

[89] *Id.* at 17-20. *See also* note 85 *supra*.

[90] *Id.* at 17-20. The *Transamerica* Court observed that Congress intended §§ 206 and 215 to benefit the clients of investment advisers. *Id.* at 17. Section 215 confers protection particularly to parties to advisory contracts. *Id.* at 18-19. In light of implicit congressional intent to protect parties to invalid advisory contracts, the Supreme Court upheld an implied private right under § 215. *Id.* at 19. In contrast to § 215, § 206 simply establishes federal fiduciary standards to govern the conduct of investment advisers. *Id.* at 19. Section 206, therefore, protects no special class of investors. The Advisers Act provides only government enforcement of § 206, *see* note 88 *supra*, unlike other federal securities laws that contain express private remedies. 444 U.S. at 20-22. The lack of private remedies, the Court reasoned, is strong evidence of congressional unwillingness to include a private right of action under § 206 within the legislative scheme of the Advisers Act. *Id.* at 21-22.

[91] *Id.* at 23-24.

[92] *Id.*

[93] *Id.* The plaintiffs in *Transamerica* argued that the *Cort* test required consideration of the fourth *Cort* factor in addition to determination of congressional intent. *Id.* The *Transamerica* Court rejected this argument and reiterated that the *Cort* factors are not of equal weight. *Id.* Citing *Redington*, the Court held that a determination that congressional intent to imply a private right is absent will preclude further inquiry. *Id.* at 24.

[94] The *Transamerica* and *Redington* Courts were careful to avoid overruling *Cort*. *Red-*

fore, reorders and redefines the original *Cort* factors to create a more restrictive implication test.

Applying the *Cort-Transamerica* test to section 17(a) involves a threshold determination whether Congress intended to create private rights thereunder. The initial level of inquiry, therefore, examines the express language and legislative history of section 17(a).[95] The language of section 17(a) limits its protective scope to frauds committed in the context of an offer or sale of securities.[96] Section 17(a)(1) disallows employment of deceptive schemes in securities transactions.[97] The language of section 17(a)(1), however, confers no special rights on any group of investors. Similarly, the text of section 17(a)(2) fails to create any civil liabilities, although that subsection generally proscribes misstatements and omissions.[98] Subsection (3) of section 17(a) forbids conduct that might "operate as a fraud upon the purchasers."[99] Since section 17(a)(3) makes specific reference to purchasers, subsection (3) appears to identify purchasers as a special class.[100] The text of subsection (3), however, simply describes the object of fraudulent conduct without providing for civil liability.[101] The express language of section 17(a), therefore, does not create any private rights thereunder.[102]

The holding in *Transamerica* supports this conclusion.[103] The lan-

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*ington* held that the *Cort* factors are not of equal weight. 442 U.S. at 575. Similarly, the *Transamerica* Court avoided foreclosing consideration of the fourth *Cort* factor. If congressional intent fails to support a private right, denial of implied private rights results. *See* note 93 *supra*. If the traditional indicia of legislative intent support implication of a private remedy, however, the *Transamerica* analysis does not prevent examination of state remedies.

[95] *See* text accompanying notes 85-86 *supra*.

[96] *See* 3 Loss, *supra* note 15, at 1785; note 7 *supra*.

[97] *See* note 7 *supra*. Some courts maintain that the language of § 17(a)(1) is broad enough to support a private right of action based on common law fraud. *See, e.g.*, Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1245 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979); Lanza v. Drexel & Co., 479 F.2d 1277, 1280 n.2 (2d Cir. 1973). The Supreme Court, however, held that violation of a federal statute and injury to a person does not give rise automatically to an implied right in favor of that person. *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979).

[98] *See* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978); note 7 *supra*. Some courts permit private actions under § 17(a)(2) if the procedural requirements of § 12(2) are met. *See* Wulc v. Gulf & Western Indus., Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1095 (E.D. Pa. 1972); *see* text accompanying notes 128-31 *infra*.

[99] *See* note 7 *supra*.

[100] *See* Demoe v. Dean Witter & Co., 476 F. Supp. 275, 279 (D. Alaska 1979). *But see* United States v. Naftalin, 441 U.S. 768, 773-74 (1979). The Supreme Court recently interpreted § 17(a)(3) as referring to the impact fraudulent conduct may have on a purchaser. *Id.*

[101] *See id.*

[102] *See* text accompanying notes 81-82 *supra*.

[103] *Compare* 15 U.S.C. §§ 77q(1), 77q(3) (1976) *with* 15 U.S.C. §§ 80b-6(1), 80b-6(2) (1976). Sections 17(a)(1) and 206(1) prohibit the use of any device, scheme, or artifice to defraud. Sections 17(a)(3) and 206(2) forbid engaging in a transaction, practice, or course of business that operates as a fraud or deceit upon a purchaser or a client of an investment

guage of section 17(a)(1) and (3) is virtually identical to that of section 206(1) and (2) of the Advisers Act.[104] The *Transamerica* Court's determination that the language of section 206 fails to provide private rights logically extends to the language of section 17(a). An interpretation of the language of section 17(a)(1) and (3) under *Transamerica,* therefore, militates against implying private rights under those subsections.

The language of section 17(a), however, is not the sole determinative factor in the *Cort-Transamerica* implication analysis. The initial inquiry under *Cort-Transamerica* also examines the historical sources behind section 17(a).[105] The legislative history of section 17(a) reveals that Congress enacted section 17(a) in 1933 and has made no subsequent amendments.[106] Each subsection, therefore, shares the same historical source. The meagre legislative history behind section 17(a) fails to address the issue of private rights.[107] There is no indication, however, that Congress contemplated private enforcement of section 17(a).[108] In the face of legislative silence behind section 206, the *Transamerica* Court was reluctant to imply private rights where the plain language of section 206 does not provide for implication.[109] Similarly, neither the legislative history nor the express language of section 17(a), therefore, support private rights of action. Thus, if the Supreme Court refused to imply private rights under section 206 in *Transamerica,* the Court will also refuse to imply private rights under section 17(a). Since the first level of the *Cort-Transamerica* test remains unsatisfied, the implication inquiry ordinarily would end with a denial of private rights under section 17(a). Although traditional implication analysis would examine the first, third, and fourth elements of the *Cort* test, the *Cort-Transamerica* test would consider the remaining modified *Cort* factors only if the statute satisfies the threshold inquiry.

The second *Cort-Transamerica* inquiry reinforces the denial of private rights under the examination of the language and legislative history of section 17(a). The second step in the *Cort-Transamerica* implication analysis identifies the beneficiaries and the purpose of section 17(a). The Supreme Court recently held that the general purpose of section 17(a) is to protect investors and securities market mechanisms from fraudulent practices.[110] As a broad antifraud provision, section 17(a) does not benefit

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adviser, respectively.

[104] *See* text accompanying note 86 *supra.*

[105] The only amendment to § 17(a) inserted "offer or" before the word "sale" in the introductory paragraph. Act of Aug. 10, 1954, Title I, § 10, 68 Stat. 686. The amendment redefined the term "sale" to distinguish between offers and sales. *See* 15 U.S.C. § 77b(3) (1976).

[106] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 6 (1933); S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). *See also Scienter and Section 17(a), supra* note 11, at 1258-60.

[107] *See* 3 Loss, *supra* note 15, at 1785-86.

[108] 444 U.S. at 19-21.

[109] *See* text accompanying note 87 *supra.*

[110] United States v. Naftalin, 441 U.S. 768, 771-72 (1979).

a special class, but rather the investing public in general.[111] Even assuming investors and financial intermediaries protected by section 17(a) constitute a special class,[112] *Transamerica* nonetheless held that protection of a particular class is insufficient to support a private cause of action without evidence of congressional intent to do so.[113]

Congress drafted section 17(a) to prohibit frauds in the offer or sale of securities.[114] Thus, offerees and purchasers frequently claim to be special classes receiving the benefit of section 17(a) protection.[115] The "offer or sale" language describes the type of proscribed activities, instead of the particular persons affected by the fraud.[116] Purchasers and offerees receive antifraud protection as a result of government enforcement of the salutary purpose of section 17(a).[117]

In conjunction with the statutory purpose determination, the *Cort-Transamerica* analysis considers whether a private cause of action is necessary to effectuate the purpose of section 17(a).[118] The close relationship between the '33 and '34 Acts requires the examination of alternatives for investor redress under both Acts.[119] Congress drafted section 10(b), filling the gap in protection afforded by section 17(a), to prohibit fraudulent practices in the sale or purchase of securities.[120] The antifraud purposes of sections 10(b) and 17(a), therefore, are similar. Neither section, however, provides an express private right.[121] In light of the private remedies

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[111] *Id.* at 772-77.

[112] *See id.* at 772; text accompanying notes 43-48 *supra.*

[113] 444 U.S. at 23-25; *see* text accompanying note 91 *supra.*

[114] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 7 (1933).

[115] *See, e.g.,* Reid v. Madison, 438 F. Supp. 332, 335 (E.D. Va. 1977) (non-purchaser has standing to assert implied remedy under § 17(a)); *accord,* Bosse v. Crowell, Collier & MacMillan, 565 F.2d 602, 610 n.12 (9th Cir. 1977) (dicta). *See generally* Hazen, *supra* note 25, at 659-66.

[116] *See* United States v. Naftalin, 441 U.S. 768, 773 (1969). In *Naftalin,* the Supreme Court interpreted the "offer or sale" phrase in § 17(a) to determine the ambit of § 17(a) antifraud protection. *Id.* The Court held that this phrase refers to frauds in the context of an offer or sale, rather than to the victim of the fraudulent behavior. *Id.*

Denial of implied rights under § 17(a) in favor of offerees receives support from the Supreme Court decision in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *Blue Chip* held that offerees lack standing to assert implied rights under Rule 10b-5. *Id.* at 755. Implication of private rights for offerees, the Court observed, would increase vexatious litigation, difficulty in proving injury, and excessive awards for damages. *Id.* at 739-49. Furthermore, the Court regarded the express remedies contained in §§ 11 and 12 of the '33 Act as ample evidence that Congress did not wish to extend private rights to non-purchasing offerees for lost investment opportunities. *Id.* at 754.

[117] *See* notes 3 & 4 *supra.*

[118] *See* text accompanying note 90 *supra.*

[119] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727-30 (1975); SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969).

[120] H.R. REP. No. 1383, 73d Cong., 2d Sess. 12-13 (1934); *see* Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-51 (1972); E. GADSBY, 11A BUSINESS ORGANIZATIONS § 5.02(3), at 20 n.27 (1979) [hereinafter cited as GADSBY].

[121] *Compare* 15 U.S.C. §§ 77q(a), 78j(b) (1976) *with* 15 U.S.C. §§ 77k, 77l(2), 78i(e),

afforded purchasers and sellers, Congress conceivably did not anticipate private enforcement of sections 10(b) or 17(a).[122] Courts clearly recognize implied private rights under section 10(b) and Rule 10b-5 promulgated thereunder.[123] The texts of Rule 10b-5 and sections 17(a)(1) and (3), however, are nearly identical.[124] Defrauded purchasers and sellers, upon proof of scienter, may proceed under section 10(b) and Rule 10b-5.[125] Private enforcement of negligent violations of section 17(a) creates a remedy considerably broader in scope than under section 10(b).[126] Private remedies for wilfull violations of sections 17(a)(1) and (3) duplicate private means for redress under section 10(b).[127] Implication of private rights under sections 17(a)(1) and (3) undercuts the regulatory scheme envisioned by Congress and, therefore, is unnecessary to effectuate the protective purpose of the '33 and '34 Acts.

The '33 Act creates express civil liabilities under two statutes protecting purchasers. Section 12(2) protects purchasers from misstatements or omissions in written or oral communications.[128] Similarly, section 11 prohibits falsehoods and omissions in the registration statement.[129] Both sections specifically confer private rights upon purchasers, although each provision contains strict procedural requirements.[130] Section 17(a)(2),

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78p(b), 78r(a) (1976).

[122] *See* note 3 *supra*.

[123] The first case to imply private rights under § 10(b) and Rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). Twenty-five years later, the Supreme Court confirmed the overwhelming consensus among lower courts that these private rights exist. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[124] *Compare* 15 U.S.C. §§ 77q(a)(1), 77q(a)(3) (1976) *with* 17 C.F.R. § 240.10b-5 (1979). The SEC promulgated Rule 10b-5 under § 10(b) and extended the language of § 17(a) to apply to purchases and sales. GADSBY, *supra* note 120, § 5.04(1) at 30. Section 17(a), however, does not contain the phrase "manipulative or deceptive device" found in § 10(b). Unlike Rule 10b-5 claims, state and federal courts have jurisdiction over § 17(a) actions. *See* 15 U.S.C. § 77v (1976).

[125] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).

[126] *See* Sanders v. John Nuveen & Co., 554 F.2d 790, 795 (7th Cir. 1977); Valles Salgado v. Piedmont Capital Corp., 452 F. Supp. 853, 858 (D.P.R. 1978); Malik v. Universal Resources Corp., 425 F. Supp. 350, 363 (S.D. Cal. 1976). The *Redington* decision asserted the Court's reluctance to imply a cause of action that is significantly broader than the remedies Congress chose to provide. Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979). *See* Steinburg, *supra* note 34, at 181.

[127] *But see* Schaefer v. First Nat'l Bank of Lincolnwood, 509 F.2d 1287, 1292 (7th Cir. 1975) (remedies provided by § 10(b) and other sections of '34 Act are cumulative rather than mutually exclusive); Hazen, *supra* note 25, at 658.

[128] 15 U.S.C. § 771 (2) (1976).

[129] 15 U.S.C. § 77k (1976).

[130] Sections 11 and 12(2) are subject to the statute of limitations contained in § 13. *See* 15 U.S.C. § 77m (1976). Actions brought under §§ 11 and 12(2) must commence within one year from the date of discovery of the misleading nature of a statement or after the discovery should have been made by exercise of reasonable minds. *Id.* Section 11 claims fail if brought three years after the public offering, while § 12(2) claims fail if brought three years after the sale of a security. *Id.* A court may assess court costs and attorneys' fees against either party. 15 U.S.C. § 17k(e) (1976); *see* GADSBY, *supra* note 120, § 5.02(2) at 11. Sections

however, prohibits the same type of conduct as would sections 11 and 12(2) if stripped of their procedural safeguards.[131] A private remedy under section 17(a)(2) would, therefore, duplicate existing remedies and nullify the limitations imposed by Congress.[132] Clearly, Congress did not intend to emasculate the express remedies provided for private plaintiffs. Since Congress expressly created such a remedy in section 12(2), the Supreme Court should be reluctant to imply a similar, but more expansive remedy under section 17(a)(2).[133] Implied private rights under section 17(a), therefore, are unnecessary to protect any special class and are inconsistent with the congressional goal of safeguarding the securities market and investors from fraud.

Although the purpose and scope of section 17(a) militate against implication, consideration of the fourth *Cort* factor is the final level of inquiry under the *Cort-Transamerica* test. If a statute meets the first two levels of inquiry, the modified implication test examines the statutory remedy in light of state law. *Transamerica,* however, reorders the priority and weight assigned to the original *Cort* factors.[134] The least important element of the *Cort-Transamerica* analysis is a determination whether the cause of action is one traditionally relegated to state law.[135] The national securities market is clearly an industry subject to the pervasive influence of federal securities laws.[136] Federal legislative schemes regulate securities market mechanisms and provide express private remedies for securities violations.[137] In light of the purpose and scope of federal securities laws, a private right of action for fraud in this context is not an area traditionally relegated to state law.[138] The fourth *Cort* factor, therefore, encourages implication under section 17(a). However, the most important implication element, congressional intent, outweighs the state law considerations and fails to support private rights under section 17(a).

In light of the Supreme Court's conservative approach to implying private rights under federal securities laws, neither the narrow focus of the *Transamerica* implication inquiry, nor the refusal to imply a private remedy under an antifraud provision, is surprising. Although the Supreme Court has not confronted the controversial issue whether an implied pri-

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11 and 12(2) impose a negligence standard on the plaintiff. *Id.* at 11 & 15. In addition, § 12(2) contains a privity requirement and permits a plaintiff to sue only his immediate seller. *But see id.* at 17 (liability imposed on agents, attorneys, and corporate officials not in privity with purchaser).

[131] *See* note 7 *supra;* text accompanying notes 128-30 *supra. But see* Hazen, *supra* note 25, at 644-45.

[132] *See* Sanders v. John Nuveen & Co., 554 F.2d 790, 796 (7th Cir. 1977); Wulc v. Gulf & Western Indus., Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1095 (E.D. Pa. 1972).

[133] *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979).

[134] *See* text accompanying notes 83-94 *supra.*

[135] *See* text accompanying notes 93-94 *supra.*

[136] *See* note 1 *supra.*

[137] *See* text accompanying notes 1 & 3 *supra.*

[138] *See* Steinberg, *supra* note 34, at 182.

vate right of action exists under section 17(a) of the '33 Act,[139] the *Transamerica* decision forecloses the implication of private rights under section 17(a). The language and legislative history of section 17(a) do not indicate any congressional intent to imply private rights.[140] Section 17(a) fails to meet the threshold inquiry of the *Cort-Transamerica* analysis, and, therefore, does not support implication of private rights thereunder.

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[139] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n.6 (1975).
[140] *See* text accompanying notes 95-109 *supra*.