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V. Implied Private Rights Of Action

only to sellers and can be negligently violated. The linguistic battle carried on by the courts under the present securities laws should be resolved by congressional enactment of the ALI Proposed Federal Securities Code. Adoption of the Code would allow decisions to be based on policy rather than distinctions in statutory terminology.

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V. IMPLIED PRIVATE RIGHTS OF ACTION

INTRODUCTION

Although the various federal securities laws[1] often do not explicitly provide for enforcement through private claims, the federal courts generally have recognized implied private rights of action under certain sections of the laws.[2] The Supreme Court first acknowledged that a private plaintiff might maintain a cause of action under federal securities statutes not expressly providing such a right in *J.I. Case Co. v. Borak.*[3] The plaintiff in *Borak* sought relief as a stockholder under section 14(a) of the Securities Act of 1933[4] (the '33 Act) for damages sustained from the circulation of misleading proxy solicitations.[5] Although the statute created no explicit private cause of action,[6] the Court construed section 27 of the '33 Act[7] to provide the federal courts with a broad jurisdictional mandate to entertain such suits.[8] The Court stated that because the SEC alone could not adequately enforce the proxy solicitation regulations, the implication of pri-

[1] The major federal securities acts include: the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1976); 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); and the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 21 (1976).

[2] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[3] 377 U.S. 426 (1964).

[4] Section 14(a) of the Securities Act of 1933 prohibits the solicitation of proxy statements in contravention of the rules and regulations promulgated by the SEC governing such activities. 15 U.S.C. § 78n (1976). The provision does not expressly provide for private enforcement actions or remedies.

[5] J.I. Case Co. v. Borak, 377 U.S. 426, 429-30 (1964). The plaintiff in *Borak* was a stockholder of J.I. Case who asserted that the directors of the company had circulated a false and misleading proxy statement in order to obtain approval of a proposed merger between J.I. Case and the American Tractor Company. The plaintiff sought both equitable relief to dissolve the merger and damages for himself and other shareholders. *Id.*

[6] *See* note 4 *supra.*

[7] Section 27 of the Securities Act of 1933 grants federal courts exclusive jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by this chapter. . . ." 15 U.S.C. § 78aa (1976).

[8] J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

vate remedies was necessary to effectuate the congressional purpose of protecting investors.[9] Striking an expansive note, the Court reasoned that the judiciary had a duty to be alert to provide such implied remedies under the securities laws.[10] Following the *Borak* rationale, lower courts thereafter construed federal securities statutes liberally to afford private plaintiffs causes of action under several other sections.[11]

During the past five years, however, the Supreme Court has adopted a more restrictive posture towards private plaintiffs under the federal securities laws.[12] The Court has limited the class of private litigants under those sections that already support implied private rights by imposing restrictive standing requirements.[13] In addition, the Court has increased the plaintiff's burden of proof in certain actions by requiring proof of elements of deception and scienter.[14] To avoid these restrictions, many plaintiffs now claim under sections of the securities laws where private rights have not yet been conclusively established.[15] Private plaintiffs claiming under these new sections, however, have confronted the more restrictive standard announced by the Court in *Cort v. Ash*[16] to determine whether a particular federal statute supports an implied private right of action.

In *Cort,* the Supreme Court addressed the issue of whether a private plaintiff could maintain an action against an alleged violator of the Federal Election Campaign Act.[17] In denying such a right,[18] the Court identified

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[9] *Id.* at 432-33.

[10] *Id.* at 433.

[11] *See, e.g.,* Moses v. Burgin, 445 F.2d 369 (1st Cir.), *cert. denied sub. nom.* Johnson v. Moses, 404 U.S. 994 (1971) (implied private right under the Investment Companies Act, 15 U.S.C. § 80a (1976)); Wachovia Bank & Trust Co. v. National Student Marketing Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,603 (D.D.C. Nov. 20, 1978) (implied right of action under section 17(a) of the 1933 Act, 15 U.S.C. § 78g (1976)).

[12] *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]; *1977-1978 Securities Law Developments,* 35 WASH. & LEE L. REV. 757, 859-67 (1978).

[13] The Supreme Court has recently restricted private actions under several sections of the federal securities laws. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court ruled that proof of scienter was required in a Rule 10b-5 action. The Court also concluded that no violation of section 13(d)(1) occurred where the failure to disclose was made in good faith and the plaintiff suffered no injury from the omission in Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975). *See generally* Lowenfels, *supra* note 12, at 891.

[14] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See also* note 13 *supra.*

[15] *See, e.g.,* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. 1979); Lewis v. Transamerica Corp., 575 F.2d 237 (9th Cir.), *cert. granted,* 99 S.Ct. 348 (1978).

[16] 422 U.S. 66 (1975).

[17] Cort v. Ash, 422 U.S. 66, 70-71 (1975). Corporations are prohibited from making contributions in connection with federal elections by the Federal Election Campaign Act. 2 U.S.C.A. § 441b (1977 Cum. Supp.). (At the time of the alleged violation in *Cort,* however, the applicable statute was 18 U.S.C. § 610 (1970)). The plaintiff in *Cort* brought suit against the Bethlehem Steel Corp. and its corporate directors for allegedly placing certain media advertisements in connection with the 1972 Presidential election. Although the statute provided no express private remedy, the plaintiff in his capacity as a shareholder of Bethlehem sought both damages and injunctive relief. 422 U.S. at 70-72.

four factors which are relevant to determine whether a statute forms the basis for an implied cause of action.[19] Initially, the court must find that the plaintiff is a member of the class that especially benefits from the protection afforded by the statute.[20] A statute may create certain federal rights in a plaintiff that may be enforced through implied private actions. Second, the court must search for an explicit or implicit legislative intent to create or deny such a cause of action.[21] The third *Cort* factor similarly requires the court to determine whether the implication of a private right is consistent with the underlying purposes of the legislative scheme.[22] Thus, a focus on the legislative history of the statute is crucial to each of the first three *Cort* inquiries. Finally, before providing the plaintiff a federal forum for relief, the court must decide if the cause of action is one traditionally relegated to state law.[23] A determination that state law generally governs the subject matter of the suit and provides a remedy for the plaintiff to pursue bars the implication of a federal right.[24]

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[18] The Court found that the principal purpose of the statute prohibiting corporate campaign activities was to reduce the influence wielded by major corporations over federal elections, and that protecting corporate shareholders was purely a secondary effect of the statute. 422 U.S. at 82. Additionally, the Court found no legislative intent to imply a private right of action under the statute and questioned the propriety and impact of such an implication on the enforcement scheme. *Id.* at 82-84. Finally, the Court noted that ultra vires acts of corporations were traditionally concerns of state law. *Id.* at 84. Therefore, the Court refused to imply a private right of action in favor of the plaintiff-stockholder under the Federal Election Campaign Act. *Id.* at 85.

[19] *Id.* at 78. The Court stated that the following issues are relevant in determining whether a federal statute creates an implied private right of action:

> 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?

Id.; see text accompanying notes 20-24 *infra. See also* Comment, *Implying Private Causes of Actions From Federal Statutes:* Amtrak *and* Cort *Apply the Brakes,* 17 B.C. INDUS. & COM. L. REV. 53 (1975).

[20] Cort v. Ash, 422 U.S. 66, 78 (1975).

[21] *Id.*

[22] *Id.* Because the third *Cort* factor requires a court to analyze the entire legislative scheme underlying a statute, a court should not imply a private right of action where Congress already has provided alternative remedies for the plaintiff. *See* Touche Ross & Co. v. Redington, 99 S.Ct. 2479, 2488 (1979).

[23] Cort v. Ash, 422 U.S. 66, 78 (1975). Although the *Cort* inquiry is directed at whether a cause of action is a matter of state concern, courts often examine whether state law provides the plaintiff with a remedy. *See, e.g.,* Redington v. Touche Ross & Co., 592 F.2d 617, 623 (2d Cir. 1978), *rev'd* 99 S.Ct. 2479 (1979).

[24] One commentator has suggested that there are three facets to the fourth inquiry of the *Cort* analysis. First, a court should determine if the action was one traditionally relegated to state law. Second, the action should be in an area of basic concern to the state. Finally, it is necessary for a court to determine if inferring a private action under the statute is inappro-

The Supreme Court subsequently applied the *Cort* standard to federal securities statutes in *Piper v. Chris-Craft Industries, Inc.*[25] In *Chris-Craft,* the plaintiff-offeror sought to enforce a private right of action against a competing tender offeror under section 14(e) of the Securities Exchange Act (the Williams Act).[26] After examining the legislative history and purpose of the Williams Act, the Court concluded that the Act was not intended to benefit the contestants in a takeover competition.[27] Rather, the *Chris-Craft* Court determined that the purpose of the Act was to regulate these competitors and thereby protect innocent shareholders of the target company.[28] Because the plaintiff was not a primary beneficiary of the statute,[29] the Court refused to imply a federal right from section 14(e) and denied the plaintiff standing to pursue the cause of action.[30]

The *Chris-Craft* Court applied the four-pronged analysis of *Cort v. Ash* to confirm its conclusion that Chris-Craft could not assert implied rights under the Williams Act.[31] Relying upon its analysis of the legislative history, the Court determined that the plaintiff was not a member of the class of the statute's intended beneficiaries.[32] Thus, according to the first *Cort* inquiry, Chris-Craft was not entitled any special rights or benefits under the statute.[33] Second, after examining the legislative history, the Court found no evidence that Congress explicitly or implicitly intended to create a private cause of action under section 14(e) in favor of the losing party in a tender offer contest.[34] Third, the *Chris-Craft* majority found the implication of a private right in favor of the plaintiff inconsistent with the purposes of the Williams Act because such an action might actually damage the innocent shareholders of target corporations that Congress sought to protect.[35] Finally, the Court noted that the plaintiff could pursue a state common law action for lost commercial opportunities against the defendant and that relegating the plaintiff to state law, despite the pervasive federal regulation of the securities industry, would not be inappropriate.[36]

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priate. *See* Pitt, *Standing to Sue Under the Williams Act After* Chris-Craft: A Leaky Ship *on Troubled Waters,* 34 Bus. Law. 117, 173-74 (1978) [hereinafter cited as Pitt].

[25] 430 U.S. 1 (1977).

[26] *Id.* at 9; *see* 15 U.S.C. § 78n (1976). Section 14(e) proscribes any misstatement of a material fact or any fraudulent or manipulative acts in connection with the solicitation of tendered shares. *Id.*

[27] Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977).

[28] *Id.* at 34-35.

[29] The Williams Act was designed to regulate the conduct of participants in a tender offer contest and thus fill a void in that field of federal securities law. The Supreme Court determined that it was inconsistent for Congress to have strictly regulated the conduct of tender offers as a whole while intending to protect a particular group of contestants. *Id.* at 39.

[30] *Id.*

[31] 430 U.S. at 34-41.

[32] *See* text accompanying notes 25-30 *supra.*

[33] 430 U.S. at 34-35.

[34] *Id.* at 38..

[35] *Id.* at 39.

[36] *Id.* at 40-41.

More importantly, the *Chris-Craft* Court adopted a generally restrictive stance towards private rights of action by strictly construing the *Borak* rationale for implication. Despite language in *Borak* to the contrary, the *Chris-Craft* Court held that the "institutional limitations alone" on SEC enforcement of tender offer regulations do not justify the implication of private rights.[37] Rather, the Court required proof that an implied cause of action was necessary to effectuate the congressional purposes underlying the statute, and not merely to aid in enforcement.[38]

A. *Touche Ross & Co. v. Redington: Section 17 of the Securities Exchange Act of 1934*

The Supreme Court recently affirmed this restrictive posture toward implied private rights of action under the federal securities laws in *Touche Ross & Co. v. Redington.*[39] The *Redington* case arose from the 1973 insolvency and liquidation of Weis Securities, Inc., a registered broker-dealer and member of the New York Stock Exchange.[40] The plaintiffs, the Securities Investor Protection Corp. (SIPC) and the trustee in liquidation for the brokerage firm,[41] brought an action on behalf of Weis' customers to recover damages from Touche Ross, the broker-dealer's independent accounting firm. SIPC and the trustee alleged that Touche Ross prepared and certified false and misleading financial statements in violation of section 17 of the Securities Exchange Act of 1934 (the '34 Act).[42] The plaintiffs further asserted that an implied private right of action under section 17 permitted recovery of damages for these violations.[43] After closely examining three factors of the *Cort* analysis, the Supreme Court emphatically rejected the plaintiffs' implication claim.[44] In addition to reflecting a generally conserv-

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[37] *Id.* at 25. The *Borak* Court held that because the SEC alone could not adequately enforce the proxy solicitation regulations, private enforcement was a necessary supplement to administrative actions. J. I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964).

[38] 430 U.S. at 25.

[39] 99 S.Ct. 2479 (1979).

[40] *Id.* at 2483.

[41] The plaintiff, Redington, brought the suit as trustee in liquidation of the brokerage firm to recover damages on behalf of the firm and its customers from the defendant accountants. *Id.* at 2484. Redington was joined in this action by the Securities Investor Protection Corp. (SIPC), who asserted derivative claims as the insurer of the brokerage customers. *Id.*

[42] *Id.; see* 15 U.S.C. § 78l (1976). In 1972, the date relevant to the *Redington* decision, section 17 of the '34 Act provided in relevant part:

> (a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium with any such member . . . shall make, keep, and preserve for such period, such accounts . . . and other reports, 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 . . . .

15 U.S.C. § 78q (1970). The section further provides for periodic or special inspection of such records by the commission at any time. *Id.; see* 17 C.F.R. § 240.17a-5 (1978).

[43] 99 S.Ct. at 2484.

[44] *Id.* at 2485-91; *see* text accompanying notes 58-73 *infra.*

ative attitude towards the implication of private actions under the securities statutes, the *Redington* decision provides a valuable illustration of the Court's implication analysis.

Section 17 of the '34 Act imposes certain accounting and administrative reporting requirements on brokers dealing through the national securities exchanges.[45] These brokers are required to prepare detailed financial statements certified by an independent accounting firm.[46] The SEC inspects these certified records periodically and utilizes the statements in the enforcement of the net capital rule, which ensures the solvency of the national brokers.[47] Although section 17 creates no express liabilities and imposes no duties on accountants,[48] the *Redington* plaintiffs maintained that the statute and the SEC rules promulgated thereunder imposed certain obligations on certifying accountants.[49] At trial, the district court determined that section 17 imposed no express or implied duties on accountants and therefore dismissed all claims against the defendant.[50] On appeal, the Second Circuit held that Congress and the SEC relied heavily upon the independent examination of brokers' financial statements by accountants in the enforcement scheme of the '34 Act.[51] Applying the *Cort v. Ash* analysis, the Second Circuit reversed the trial court and concluded that private plaintiffs may pursue claims against accountants who breach the duties arising under section 17.[52]

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[45] *See* 15 U.S.C. § 78q (1976); note 42 *supra*.

[46] 17 C.F.R. § 240.17a-5 (1978).

[47] 17 C.F.R. § 240.15c3-1 (1978); *see* 99 S.Ct. at 2486.

[48] *See* 15 U.S.C. § 78q (1976); note 42 *supra*.

[49] 99 S.Ct. at 2484. The plaintiffs appeared to rely initially upon a statutory tort theory to recover for Touche Ross' allegedly improper audit and certification of financial statements in 1972. *Id.* The statutory tort theory of liability is based upon the legislative purpose underlying a statute. If a court determines that a given statute protects an individual from particular damage, the court may imply a cause of action to permit a plaintiff to recover for the violation of this legislatively created interest. *See* RESTATEMENT OF TORTS § 286 (1934); W. PROSSER, THE LAW OF TORTS, § 36 (4th ed. 1971); Climan, *Civil Liability Under The Credit-Regulation Provisions of the Securities Exchange Act of 1934*, 63 CORNELL L. REV. 206, 225-26 (1978) [hereinafter cited as Climan]. *See also* RESTATEMENT (SECOND) OF TORTS § 286 (1965).

[50] Redington v. Touche Ross & Co., 428 F. Supp. 483, 491 (S.D.N.Y. 1977). The district court indicated that § 18(a) might provide the exclusive remedy for violations of § 17. *Id.* at 489-90.

[51] Redington v. Touche Ross & Co., 592 F.2d 617, 621-22 (2d Cir. 1978).

[52] *Id.* at 621-23. The *Redington* court applied the four criteria of *Cort v. Ash* to determine whether section 17 supported the implications of a private right through a statutory test analysis. The court noted that section 17 empowered the SEC to require the submission of only those documents and reports "necessary or appropriate in the public interest or *for the protection of investors.*" *Id.* at 621; *see* 15 U.S.C. § 78q(a) (1976); note 42 *supra*. Therefore, the court concluded that the primary purpose of the statute was to protect investors such as the clients of brokerage houses. The Second Circuit termed the second *Cort* factor neutral after finding no evidence that Congress implicitly or explicitly intended to deny private rights under section 17. *Id.* at 622. The court found that implication of a private right was consistent with the underlying legislative purposes, since such actions would aid in enforcing the statute and afford an essential remedy to the beneficiary class. *Id.* at 623. Finally, the Second Circuit

The Supreme Court, reversing the Second Circuit, began its analysis in *Redington* by emphasizing that the implication issue is essentially a matter of statutory construction.[53] Accordingly, the Court rejected the statutory tort theory of liability,[54] stating that violations of federal statutes do not automatically create private rights of action.[55] Rather, the *Redington* Court limited its inquiry to whether Congress explicitly or implicitly intended to create such private enforcement actions under section 17. In this regard, the Court examined three *Cort* factors - the intended beneficiaries, the legislative history, and the purpose of the statute.[56] Concluding that these criteria militated against implying a private right of action, the *Redington* Court reversed the Second Circuit without discussing the final inquiries under the *Cort-Chris-Craft* analysis.[57]

Initially focusing on the intended beneficiaries of the statute,[58] the *Redington* Court analyzed the language of section 17 to discern the congressional purpose. Acknowledging that a statute need not expressly grant a private remedy, the Court nevertheless held that the statute at least must proscribe certain conduct or confer federal rights on the private plaintiff before the judiciary may imply a private action.[59] The *Redington* Court determined that section 17 by its terms simply imposed administrative reporting requirements on broker-dealers without prohibiting any action or creating federal rights in any party.[60] This information enables the SEC to enforce the net capital rule and gives the authorities sufficient warning of broker-dealer insolvency to protect investors.[61] Although the ultimate beneficiaries of the regulatory efforts are the investing public,[62] the Court refused to conclude that Congress intended to create a retrospective implied remedy.[63]

Addressing the second *Cort* inquiry, the *Redington* Court recognized the lack of legislative history surrounding the issue of private rights under

determined that the remedy sought by the *Redington* plaintiffs was not one traditionally relegated to state law. *Id.*

[53] Touche Ross & Co. v. Redington, 99 S.Ct. 2479, 2485 (1979); *see* Cannon v. University of Chicago, 99 S.Ct. 1946, 1953 (1979) (implying a private right action under Title IX, 20 U.S.C. §§ 1681-86 (1976)).

[54] Touche Ross & Co. v. Redington, 99 S.Ct. at 2485; *see* note 49 *supra*.

[55] 99 S.Ct. at 2485; *see* Cannon v. University of Chicago, 99 S.Ct. 1946, 1953 (1979).

[56] *See* text accompanying notes 58-73 *infra*.

[57] *See* text accompanying notes 74-82 *infra*.

[58] *See* text accompanying note 20 *supra*.

[59] 99 S.Ct. at 2485.

[60] *Id.* at 2486. The *Redington* court found that section 17 of the '34 Act and Rule 17a-5 require brokers to submit financial statements certified by independent public accountants to provide an accurate financial picture. In addition, the accountants are required to list any matters to which they take exception in the broker's financial statement. *See* 17 C.F.R. § 240.17a-5 (1978).

[61] 99 S.Ct. at 2486; *see* 15 U.S.C. § 78o(c)(3) (1976); 17 C.F.R. § 240.15c3-1 (1978).

[62] 99 S.Ct. at 2486; *see* Redington v. Touche Ross Co., 592 F.2d 617, 621-22 (1978).

[63] 99 S.Ct. at 2486.

section 17 of the '34 Act.[64] The Court interpreted the meager legislative history, however, as consistent with the conclusion that private rights should not be implied.[65] In addition, the Court expressed a general reluctance to imply such rights in the face of relative legislative silence, particularly where the plain language of the statute does not support implication.[66]

According to the third *Cort* factor, the Supreme Court examined the '34 Act as an entity to determine whether the implication of a private right was consistent with the overall legislative scheme. The Court initially observed that the '34 Act contained several express private enforcement provisions, including two which flanked section 17.[67] The Court found that section 18(a) created a limited private cause of action for section 17 violations,[68] but also recognized that SIPC and the trustee could not aid themselves of this express remedy.[69] Although the *Redington* Court refrained from holding that Congress intended section 18(a) to provide the exclusive remedy for such violations,[70] the Court was reluctant to significantly expand the scope of this express remedy.[71] Therefore, the *Redington* Court concluded that the implication of a private cause of action under section 17 was inconsistent with the legislative scheme of the '34 Act.[72] Instead, the Court invited Congress to legislate a new federal damage remedy if it disagreed with the *Redington* result.[73]

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[64] *Id.*

[65] *Id.* at 2487 n.11.

[66] *Id.* at 2486-87.

[67] *Id.* at 2487; *see* 15 U.S.C. §§ 78p(b), 78r(a) (1976).

[68] 99 S.Ct. at 2487. Section 18 of the '34 Act provides in relevant part:

> Any person who shall make or cause to be made any statement in any application, report or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false and misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement. . . .

15 U.S.C. § 78r(a) (1976). The section further provides that damages suffered in reliance upon the misstatement may be recovered only where the plaintiff proves that he was acting in good faith and had no knowledge that the statement was false or misleading. *Id.*

[69] 99 S.Ct. at 2487. Section 18 affords a remedy only to those plaintiffs who purchased or sold a security in reliance on the misleading statements. *See* note 68 *supra*. Often customers of brokerage houses maintain accounts with their brokers consisting of securities and the cash proceeds from the sale of securities. The insolvency of a broker turns customers into creditors of the firm, but no purchase or sale of a security is directly involved in the failure. *See* H.R. Doc. No. 91-1613, 91st Cong., 2d Sess. (1970) *reprinted in* [1970] U.S. Code Cong. & Ad. News 5254.

[70] 99 S.Ct. at 2488. The *Redington* Court, however, noted that significant evidence supported the conclusion that § 18(a) was intended to provide this exclusive remedy. *See id.* at 2488 n.15.

[71] *Id.* at 2488.

[72] *See id.* at 2486-88.

[73] *Id.* at 2490-91.

In addition to the three criteria discussed above, *Cort v. Ash*[74] and *Piper v. Chris-Craft*[75] set forth two additional factors which are relevant in the implication analysis: (a) whether the cause of action was one traditionally relegated to state law;[76] and (b) whether implication was necessary to effectuate the statutory purposes.[77] The *Redington* Court, however, declined to examine these issues. Where both the plain language and the legislative purpose behind a statute militated against implication, the Court ruled the inquiry complete.[78] Explaining this omission, the *Redington* Court reemphasized the vital interrelationship between legislative intent and judicial implication of private rights of action.[79] The Court viewed the first three *Cort* factors as traditional indicia of legislative intent.[80] Consequently, when these factors reflect negatively on the implication issue, the Court will deem the remaining *Cort* and *Chris-Craft* factors irrelevant.[81] Significantly, the *Redington* Court revealed for the first time that each of the *Cort* and *Chris-Craft* factors will not be accorded equal weight in any implication analysis.[82] Rather, the first three inquiries concerning legislative intent may be determinative.

Finally, the *Redington* Court drastically restricted the *Borak* implication rationale[83] without actually disturbing the holding in that decision. The Court held that section 27 of the '34 Act,[84] the general jurisdictional provision, created no private rights of action.[85] Instead, the Court determined that such rights must originate in the substantive provisions of the '34 Act.[86] Additionally, the Court withdrew from the expansive remedial doctrine announced in *Borak*.[87] Acknowledging that recent decisions had applied a stricter standard for the implication of private causes of action,[88] the *Redington* Court expressly adopted this conservative approach.[89] The Court cautioned that the judiciary's function is to discern and implement

[74] 422 U.S. 66 (1975).

[75] 430 U.S. 1 (1977).

[76] *See* text accompanying note 23 *supra*.

[77] *See* text accompanying note 38 *supra*.

[78] 99 S.Ct. at 2489.

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] *See id.*

[83] *See* text accompanying notes 3-10 *supra*.

[84] 15 U.S.C. § 78aa (1976); *see* note 7 *supra*.

[85] 99 S.Ct. at 2490; *see* text accompanying notes 6-8 *supra*.

[86] 99 S.Ct. at 2490.

[87] *See* text accompanying notes 9-10 *supra*.

[88] 99 S.Ct. at 2490.

[89] *Id.* The *Redington* Court stated:

> [t]o the extent our analysis in today's decision differs from that of the Court in *Borak*, it suffices to say that in a series of cases since *Borak* we have adhered to a stricter standard for the implication of private causes of action, and we follow that stricter standard today.

Id.

congressional intent rather than to engage in a wholesale revision of a statutory scheme.[90] As the Supreme Court will soon consider implied private claims under other sections of the federal securities laws,[91] the *Redington* decision provides a valuable barometer of the current Court's generally restrictive attitude towards implied private enforcement actions. Indeed, this conservative approach has already had a significant impact on the lower courts.[92]

B. Section 206 of the Investment Advisors Act of 1940

Section 206 of the Investment Advisors Act of 1940 (the IAA) contains broad anti-fraud language designed to prohibit any manipulative or deceptive practices by investment advisors.[93] Rule 206(4)-1, promulgated under section 206 by the SEC, prohibits any investment advisor from publishing or circulating any advertisement which contains a false or misleading statement of a material fact.[94] While both section 206 and Rule 206(4)-1

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[90] *Id.*

[91] *See, e.g.*, Lewis v. Transamerica Corp., 575 F.2d 237 (9th Cir.), *cert. granted*, 99 S.Ct. 348 (1978).

[92] *See, e.g.*, Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. 1979).

[93] Section 206 of the Investment Advisors Act of 1940 provides in 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. . . .

15 U.S.C. § 80b-6 (1976).

The section further provides the SEC with the power to promulgate rules and regulations governing the conduct of investment advisors. Section 206 is similar to Rule 10b-5, 17 C.F.R. § 240.10b-5 (1978), as both provisions contain broad antifraud language. *See also* section 17 of the Securities Act of 1933, 15 U.S.C. § 77q (1976). One difference between the provisions is that Rule 10b-5 applies only where a purchaser-seller relationship is established, while section 206 protects either clients or prospective clients. Thus, section 206 is not limited as severely in its scope as Rule 10b-5 protection. *See* Note, *Private Causes of Action Under Section 206 of the Investment Advisors Act*, 74 MICH. L. REV. 308, 331-36 (1975) [hereinafter cited as *Section 206 Actions*].

[94] Rule 206(4)-1 states in relevant part:

> (a) It shall constitute a fraudulent, deceptive, or manipulating act, practice or course of business within the meaning of section 206(4) of the Act, for any investment adviser, directly or indirectly, to publish, circulate or distribute any advertisement:
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> . . . (5) Which contains any untrue statement of a material fact, which is otherwise false or misleading.
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> (b) For the purposes of this section the term "advertisement" shall include any notice, circular, letter or other written communication addressed to more than one person . . . which offers . . . any analysis, report, or publication concerning securi-

regulate the conduct of investment counselors, neither provision expressly provides for private enforcement of violations. In *Abrahamson v. Fleschner*[95] and *Wilson v. First Houston Investment Corp.*,[96] however, the Second and Fifth Circuits considered the question of implied private actions under section 206 and Rule 206(4)-1 in light of the *Cort* and *Chris-Craft* decisions.[97] Both the *Abrahamson* and *Wilson* courts concluded that these provisions support the implication of private rights of action in favor of investment clients injured through violations of the IAA.[98]

In *Abrahamson,* the plaintiffs were limited partners in an investment group established and managed by Fleschner and other general partners.[99] The partnership allegedly emphasized the conservative nature of its investment policy and portfolio holdings in its communications with the plaintiffs, thereby inducing them to join and remain associated with the group.[100] When the Abrahamsons discovered that a large percentage of the portfolio securities were unregistered,[101] they withdrew from the investment partnership. The plaintiff in *Wilson* retained the defendant as his investment counselor after learning of its innovative investment manage-

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> ties, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or . . . any other investment advisory service with regard to securities.

17 C.F.R. § 275.206(4)-1 (1978).

[95] 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 436 U.S. 905, 913 (1978).

[96] 566 F.2d 1235 (5th Cir. 1978).

[97] *See also* Lewis v. Transamerica Corp., 575 F.2d 237 (9th Cir.), *cert. granted,* 99 S.Ct. 348 (1978).

[98] *See* text accompanying notes 100-141 *infra.* The plaintiffs in both *Wilson* and *Abrahamson* also asserted claims under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1978). Wilson contended that the execution of the power of attorney over his portfolio in favor of the defendant met the purchase and sale requirements under Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975). Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1237 (5th Cir. 1978). Likewise, the Abrahamsons asserted that the 1968 modification of the investment partnership agreement constituted a purchase or sale of a security. *See* Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir. 1977). Both courts rejected these arguments and dismissed the section 10(b) and Rule 10b-5 claims.

[99] Abrahamson v. Fleschner, 568 F.2d 862, 865-66 (2d Cir. 1977). The plaintiffs, Robert and Marjorie Abrahamson, joined the investment group at its inception in 1965 as limited partners. As the investment group grew, more general partners became associated with the venture and, in 1966 and 1968, new partnership agreements were completed to include the new general and limited partners. By 1968, the group consisted of three general partners and sixty-six limited partners. *Id.* at 866.

[100] In 1964 and 1965, the plaintiffs met with Fleschner concerning the establishment of an investment partnership. The plaintiffs emphasized their desire for financial security and conservative investments, and the defendant assured them that the partnership would have such a policy. In addition, the partnership issued monthly reports containing investment performance materials and statements of policy representing a "low risk stance" and "a most conservative posture". *Id.*

[101] *Id.* at 867. Unregistered securities are investments that are not subject to registration with the SEC. These securities are subject to restrictions on further sales and, therefore, have only limited marketability. *Id.* at 867 n.3.

ment techniques.[102] The plaintiff subsequently executed a full power of attorney in favor of First Houston to enable the corporation to purchase and sell securities in his name.[103] While under the defendant's management for a year and one half, Wilson's account substantially diminished in value.[104] Not until First Houston resigned from management of the account did the plaintiff discover the extent of his losses and learn that the "innovative techniques" had never been fully utilized.[105] The plaintiffs in both *Abrahamson* and *Wilson* asserted that section 206 of the IAA and Rule 206(4)-1 created implied private rights of action enabling them to recover damages for the alleged misrepresentations and mismanagement.[106]

Both the *Wilson* and *Abrahamson* courts used the *Cort* four-pronged inquiry to analyze implied private rights under section 206 of the IAA.[107] Addressing the first factor of the *Cort* analysis, both courts determined that the plaintiffs were members of the "class for whose *especial* benefit the statute was enacted."[108] The legislative history and purpose of the IAA demonstrates a congressional intent to protect small investors from fraudulent conduct and overreaching by investment counselors.[109] Furthermore,

[102] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1237 (5th Cir. 1978). The plaintiff in *Wilson* learned from a magazine article that First Houston utilized a computer analysis technique to evaluate investments and eliminate any securities not meeting certain performance criteria. A representative of First Houston subsequently confirmed the article's contents and induced Wilson to retain the defendant as investment counselors. *Id.*

[103] *Id.* By executing the power of attorney, the plaintiff gave First Houston discretionary authority to dispose of and manage his current holdings of securities. The defendant immediately converted all of the plaintiff's investments to securities selected by First Houston. *Id.*

[104] *Id.* Wilson's portfolio declined in value from over $100,000 at the time First Houston initially began management to less than $5,500 when the defendant resigned. *Id.*

[105] *Id.*

[106] The plaintiffs in *Abrahamson* claimed damages for the injuries suffered through the investment partnership's misrepresentations. From 1966 to 1968, the firm's financial statements were prepared by another accounting firm and the 1969 report disclosed, for the first time, that a large percentage of the firm's securities were unregistered. Thereafter, the Abrahamsons withdrew from the investment partnership and brought suit against the investment group and the Goodkin accountants. 568 F.2d at 867. The plaintiffs claimed that they should recover the difference between the value of their investments in 1968 and the value when they actually withdrew from the partnership in 1970. This period represented the interval in which the investment firm acquired substantial holdings of unregistered securities. *Id.* at 867 n.6. *See also* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1237 (5th Cir. 1978).

[107] *See* text accompanying notes 109-134 *infra.*

[108] 566 F.2d at 1240; 568 F.2d at 870-71.

[109] H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940). By enacting the Investment Advisors Act of 1940, Congress intended to protect investors from certain practices of investment advisors. The report accompanying the Act in the House of Representatives stated that "this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings." *Id; see* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1240 (5th Cir. 1978); Abrahamson v. Fleschner 568 F.2d 862, 870-71 (2d Cir. 1977). *See also* S. REP. No. 1775, 76th Cong., 3d Sess. (1940); SEC, *Investment Counsel, Investment Supervisory and Investment Advisory Services,* H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

the Supreme Court previously examined the legislative history of the IAA and found that Congress intended to protect the average investor and safeguard the fiduciary relationships between client and advisor.[110] As each plaintiff retained his advisor to manage his investment and in fact delegated this responsibility to his advisor, the two courts correctly determined that section 206 and Rule 206(4)-1 created federal rights in favor of the plaintiffs.[111]

Reviewing the legislative history of the IAA, the *Wilson* and *Abrahamson* majorities failed to discern an intent to either create or deny a private right of action.[112] Although arguably Congress never considered enforcement of the Act through private suits,[113] the language of the jurisdictional statute may be read to preclude such private rights.[114] In drafting section 214 of the IAA,[115] the general jurisdictional provision, Congress omitted the words "actions at law" and gave the federal courts jurisdiction only over "suits in equity to enjoin any violation . . ." of the Act.[116] The dissents in both *Wilson* and *Abrahamson* emphasized this omission as indicative of the congressional intent to provide a limited enforcement scheme for the IAA.[117] Indeed, if the omission was calculated, Congress may have intended to preclude any private damage suits under the IAA by withholding jurisdiction, because such actions would always be "at law."[118] The Supreme Court previously has held that an explicit congressional intent to deny private actions, evidenced in the legislative history, would prohibit the implication of a private right from a statute.[119] Congress

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110 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-92 (1963).

111 Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 875-76 (2d Cir. 1977); *see Section 206 Actions, supra* note 93, at 316; Note, *Implied Private Right of Action Under Section 17 of the Securities Exchange Act of 1934,* 31 VAND. L. REV. 1513, 1524 (1978).

112 *See* text accompanying notes 114-122 *infra.*

113 Abrahamson v. Fleschner, 568 F.2d 862, 875 (2d Cir. 1977); *Section 206 Actions, supra* note 93, at 316.

114 *See* text accompanying notes 115-118 *infra.*

115 15 U.S.C. § 80b-14 (1976).

116 *Compare* 15 U.S.C. § 77v (1976) (jurisdictional section of the '33 Act) *and* 15 U.S.C. § 78aa (1976) (jurisdictional provision of the '34 Act) *with* 15 U.S.C. § 80b-14 (1976) (section 214 of the IAA).

117 *See* Abrahamson v. Fleschner, 568 F.2d 862, 881-82 (2d Cir. 1977) (Gurfein, J., concurring and dissenting).

118 *Id.* A federal court might assert general federal question jurisdiction under 23 U.S.C. § 1331 (1976) to consider such implied actions even in the absence of an explicit congressional delegation of jurisdiction. *See Section 206 Actions, supra* note 93, at 318. Resolving the jurisdictional issue, therefore, does not resolve the question of legislative intent. A court still must determine if Congress intended to exclude private enforcement actions under section 206 of the IAA.

119 Cort v. Ash, 422 U.S. 66, 82 (1975). In National R.R. Pass. Corp. v. National Ass'n of R.R. Pass., 414 U.S. 453 (1974) *(Amtrak),* the Supreme Court determined that Congress intended to deny private enforcement actions under the Rail Passenger Service Act of 1971 (the Amtrak Act), 45 U.S.C. § 501 *et seq.* In *Amtrak,* the plaintiff association brought a private action seeking to enforce the Amtrak Act and enjoin the discontinuance of certain

apparently did not regard the omission as significant, however, for both the House and Senate Reports termed section 214 of the IAA "generally comparable" to the jurisdictional provisions of other securities acts which expressly include actions at law.[120] The majorities in *Abrahamson* and *Wilson* noted that Congress failed to provide for any express private remedies in the IAA, making the inclusion of the "actions at law" language superfluous.[121] In sum, the absence of the jurisdictional language from section 214 is ambiguous on the issue of congressional intent to create or deny implied private actions based on section 206 of the Act.[122]

The *Abrahamson* and *Wilson* courts then addressed the third *Cort* inquiry, whether the implication of a private right is consistent with the underlying legislative purpose. The objective of the IAA is to protect the small investor by regulating investment counseling practices.[123] The only remedy for investment clients under the Act is filing a complaint with the SEC, and even this remedy is not compensatory.[124] The implication of a private remedy under section 206 is consistent with the enforcement rationale of the *Borak* decision.[125] In addition, such an action would permit innocent investors to recover for injuries sustained through breaches of their advisors' fiduciary duties.[126] Furthermore, the Supreme Court has previously directed that the IAA should be construed flexibly to effectuate its remedial purposes.[127] The implication of a private right under section 206 benefits the protected class of small investors, aids in the enforcement of the IAA and, therefore, seems consistent with the remedial legislative

passenger trains. 414 U.S. at 454. The *Amtrak* Court held that the Act conferred exclusive enforcement power on the Attorney General, with only a limited exception in the case of labor agreements. *Id.* at 464. The Court found significant evidence in the legislative history of the Act that Congress considered and rejected the alternative of enforcement through general private actions. *Id.* at 458-61. Thus, the *Amtrak* Court refused to imply a private right of action under the Act based on both the omission of express provisions in the statute and additional evidence of legislative intent. In contrast, analyzing implied rights under section 206 of the IAA, the evidence shows that Congress never explicitly considered the question of private actions under the IAA. Abrahamson v. Fleschner, 568 F.2d 862, 876 n.23 (2d Cir. 1977). Therefore, reliance upon merely the statutory omission of jurisdiction to preclude private rights under section 206 is inappropriate.

[120] *See* Abrahamson v. Fleschner, 568 F.2d 862, 875 (2d Cir. 1977). *See also* S. REP. No. 1775, 76th Cong., 3d Sess. 23 (1940); H.R. REP. No. 2639, 76th Cong., 3d Sess. 30 (1940).

[121] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1241-42 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 874-75 (2d Cir. 1977).

[122] *See* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1242 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 875 (2d Cir. 1977); *Section 206 Actions, supra* note 93, at 316-20.

[123] *See* text accompanying notes 61-62 *supra.*

[124] *See* 15 U.S.C. § 80b-9 (1976) (section 209 of the Investment Advisors Act); 15 U.S.C. § 80b-3 (1976) (section 203 of the IAA). *See also Section 206 Actions, supra* note 93, at 321.

[125] *See* text accompanying notes 10-11 *supra. But see* text accompanying notes 83-90 *supra.*

[126] *See Section 206 Actions, supra* note 93, at 321.

[127] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963), *cited in* Abrahamson v. Fleschner, 568 F.2d 862, 875 (2d Cir. 1977).

purposes of the Act.[128]

Finally, in accordance with the *Cort v. Ash* analysis, the *Wilson* court examined relevant state law to determine if the cause of action was one traditionally relegated to state law.[129] The *Wilson* court, however, recognized that the common law provided little protection to the investor from the fraudulent conduct of his advisor.[130] The Supreme Court has noted the limitations of the common law doctrine of fraud in dealing with the sale of intangibles such as investment advice.[131] Although many states have recently adopted anti-fraud statutes designed to protect investors from fraudulent counseling practices,[132] many legislatures patterned their statutes after the federal laws.[133] Therefore, the *Wilson* majority concluded that the pervasive federal regulation of the securities industry justified the implication of a federal cause of action for fraudulent investment advisor conduct.[134]

Before implying a private cause of action based on a federal statute, the *Chris-Craft* decision requires a court to address the necessity of such an action.[135] Both the *Wilson* and *Abrahamson* courts found that a denial of such a private right would undermine and defeat the purposes of federal regulation of investment advisors.[136] In addition, the *Wilson* court could ascertain no alternate means of achieving the congressional goal of protecting investors and noted no adverse impact on the beneficiary class by implying a cause of action.[138] Such holdings necessarily imply that the express enforcement provisions of the IAA delegated to the SEC are incapable of adequately regulating the field.[138] Nevertheless, after *Chris-Craft* and *Redington,* a reliance on the enforcement rationale alone is insufficient

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[128] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1242 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 873-74 (2d Cir. 1977); *see Section 206 Actions, supra* note 93, at 321.

[129] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1242-43 (5th Cir. 1978). Unfortunately, the *Abrahamson* court did not address the state law issue in its decision.

[130] *Id.* at 1242.

[131] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192 (1963). The Court acknowledged that common law fraud developed around transactions involving tangible property such as land and had limited applicability in many current settings. A plaintiff in a common law fraud action is often handicapped by the strict requirements of proof of actual damages and reliance. *Id.*

[132] *See, e.g.,* CAL. CORP. CODE § 25235 (West 1977); ILL. ANN. STAT. ch. 121 ½, § 137.12J (Smith-Hurd 1978 Cum. Supp.); IND. CODE ANN. § 23-2-12.1 (Burns 1978 Cum. Supp.); MICH. COMP. LAWS. ANN. § 451.502 (1978-1979 Cum. Supp.); N.J. STAT. ANN. § 49:3-53 (West 1970); OHIO REV. CODE ANN. § 1707.42 (Page 1978); VA. CODE ANN. § 13.1-503 (1978).

[133] *See Section 206 Actions, supra* note 93, at 322.

[134] Wilson v. First Houston Inv. Corp., 566 F.2d at 1242.

[135] *See* text accompanying notes 37-38 *supra.*

[136] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 876 (2d Cir. 1977).

[137] Wilson v. First Houston Inv. Corp., 566 F.2d at 1243.

[138] *See* Abrahamson v. Fleschner, 568 F.2d 862, 874 (2d Cir. 1977). *See also* text accompanying note 9 *supra.*

to support the implication of private rights.[139] The crucial test now is whether the congressional purposes will be frustrated in the absence of such rights.[140] The *Wilson* and *Abrahamson* courts reasoned that the protection of investors would be defeated absent the additional enforcement and compensation provided through private causes of action.[141] Therefore, under the majority analyses in *Wilson* and *Abrahamson,* the plaintiffs satisfied the implication tests of *Cort* and the necessity requirement of *Chris-Craft.*

The dissenting opinions in *Wilson* and *Abrahamson* recognized and emphasized entirely different legislative purposes behind the Investment Advisors Act of 1940.[142] The dissenters maintained that the Act was primarily designed as a census mechanism to gather information about the industry through registration requirements.[143] To avoid undue disruption of the investment advisory industry, the dissenters noted that Congress also imposed a code of conduct on advisors to be enforced by the SEC.[144] Such an analysis is consistent with the limited express enforcement scheme established by Congress because SEC injunctive actions to enjoin violations of the Act would always proceed in equity.[145] More importantly, this view of the IAA makes the implication of private actions in favor of investment clients unnecessary to effectuate the underlying legislative purposes.[146] The plaintiffs no longer assert especial federal rights derived from the statute but rather benefit indirectly from the provisions of the Act.[147] Consequently, according to the standards of *Cort* and *Chris-Craft,*

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[139] *See* text accompanying notes 37-38, 83-90 *supra.*

[140] *See* text accompanying note 38 *supra.*

[141] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862, 876 (2d Cir. 1977).

[142] Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243-44 (5th Cir. 1978) (Hill, J., dissenting); *see* Abrahamson v. Fleschner, 568 F.2d 862, 879-80 (2d Cir. 1977) (Gurfein, J., concurring and dissenting).

[143] 566 F.2d at 1243-44; 568 F.2d at 879-80. The legislative history of the Investment Advisors Act shows that the SEC viewed the registration and reporting requirements as a mechanism to gain data about the industry. One representative of the SEC viewed the compilation of this background information as a preliminary step towards more comprehensive regulation of investment advisors. *See* Abrahamson v. Fleschner, 568 F.2d 862, 879-80 (2d Cir. 1977) (Gurfein, J., concurring and dissenting). *See also Hearings on S. 3580 before the Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 48 (1940).

[144] *See* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1244 (5th Cir. 1978) (Hill, J., dissenting).

[145] Abrahamson v. Fleschner, 568 F.2d 862, 880-81 (2d Cir. 1977) (Gurfein, J., concurring and dissenting).

[146] *See id.* If the purpose of the IAA was merely to effect a compulsory census of the securities industry and to initiate federal registration of investment advisors, then implication of private remedies in favor of defrauded clients would not aid in achieving this objective. *Id.*

[147] *Cf.* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) (court determined that plaintiff was not a beneficiary of section 7 of the '34 Act, 15 U.S.C. § 78g (1976)); text accompanying notes 58-63 *supra.*

the dissenters in *Wilson* and *Abrahamson* concluded that the implication of private actions under section 206 of the IAA was inappropriate.[148]

The legislative history of the IAA supports both the majority and dissenting interpretations of the congressional purposes underlying the Act.[149] However, the Supreme Court previously has held that a fundamental purpose of the IAA included the protection of small investors.[150] Thus, section 206 not only proscribes specific conduct[151] but evidences a specific intent to protect a special class. According to the *Redington* analysis, that intention may be determinative of the implication question.[158] Therefore, the majority positions in *Wilson* and *Abrahamson* logically extend the protection of the Act by affording investors implied private rights of action under section 206.[159] In light of its recently restrictive approach to implied rights, however, the Supreme Court may not affirmatively endorse private actions under section 206.

C. Section 7 of the Securities Exchange Act of 1934

Section 7 of the '34 Act is essentially a credit regulation statute dealing with broker margin requirements and administered by the Federal Reserve Board.[154] The statute does not explicitly provide for private enforcement or remedies for violations of the provision.[155] Nevertheless, federal courts have liberally implied private rights of action in favor of brokerage customers injured through such margin violations.[156] Recent decisions, however, have reevaluated the implication of private rights under section 7 in light

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[148] Abrahamson v. Fleschner, 568 F.2d 862, 879 (2d Cir. 1977) (Gurfein, J., concurring and dissenting); Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1245 (5th Cir. 1978) (Hill, J., dissenting).

[149] *See* notes 109 and 143 *supra.*

[150] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-92 (1963).

[151] *See* note 93 *supra. See also* text accompanying notes 58-63 *supra.*

[152] *See* text accompanying notes 78-82 *supra.*

[153] *Accord* Lewis v. Transamerica Corp., 575 F.2d 237 (9th Cir.), *cert. granted,* 99 S.Ct. 348 (1978).

[154] 15 U.S.C. § 78g (1976). Section 7 of the '34 Act provides in relevant part:

> (c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extention or maintenance of credit to or for any customer—
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> (1) on any security (other than an exempted security) in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe . . . .

Id.

[155] *See* 15 U.S.C. § 78g (1976).

[156] *See, e.g.,* Goldman v. Bank of Commonwealth, 467 F.2d 439 (6th Cir. 1972); Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied* 401 U.S. 1013 (1971); Junger v. Hertz, Neumark & Warner, 426 F.2d 805 (2d Cir. 1970), *cert. denied* 400 U.S. 880 (1971). *But see* Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164 (10th Cir. 1977); Carras v. Burns, 516 F.2d 251 (4th Cir. 1975).

of *Cort v. Ash* and *Piper v. Chris-Craft.*[157] These courts have generally concluded that brokerage customers may not assert private causes of action under the statute.[158] A recent Fourth Circuit opinion, *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,*[159] exemplifies this trend away from implied rights under section 7 of the '34 Act.

The plaintiff in *Stern* sought compensation for losses incurred during a course of trading which alledgedly violated federal margin requirements.[160] He asserted that these requirements permitted only cash purchases of "call options," but that his broker, Merrill Lynch, wrongfully extended him credit to make such purchases.[161] Stern contended that section 7 and Regulation T,[162] promulgated thereunder by the Federal Reserve Board, afforded him an implied right of action against his broker. Section 7 and Regulation T, however, only expressly permit civil and criminal enforcement of the margin requirement by the SEC or the Attorney General.[163] Consequently, the *Stern* court applied the *Cort* and *Chris-Craft* criteria to analyze the implication of private causes of action under section 7.

The *Stern* court initially engaged in an extensive review of the historical implication theories and their application to section 7.[164] Thereafter, the court examined the legislative history of the statute to determine whether Congress intended to afford the plaintiff's class special protection through the margin regulations. The Fourth Circuit found that the primary objective of section 7 was to provide a macro-economic control over extensions of credit in the securities exchanges.[165] Margin regulations serve to protect the economy from the pyramiding effects of unrestricted margin trading, which in turn generate instability in the financial markets.[166] Of

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[157] *See* Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164 (10th Cir. 1977); Tucker v. Janota, [Current] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. Nov. 1, 1978); Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485 (S.D.N.Y. 1977); Schy v. FDIC, [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,242 (E.D.N.Y. 1977).

[158] *See* note 157 *supra*. *See generally,* Climan, *Civil Liability Under The Credit-Regulation Provisions of the Securities Exchange Act of 1934,* 63 CORNELL L. REV. 206 (1978) [hereinafter cited as Climan]; Note, *Implied Private Actions for Federal Margin Violations: The* Cort v. Ash *Factors,* 47 FORDHAM L. REV. 242 (1978) [hereinafter cited as *Federal Margin Violations].*

[159] [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979).

[160] *Id.* at 95,910-912.

[161] *Id.*

[162] 12 C.F.R. §§ 220.1-.8 (1979).

[163] *See* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,528 (D. Md. 1978) at 94,087.

[164] The *Stern* court reviewed the origins and development of both the statutory tort theory of liability and the enforcement rationale behind implication of private actions. Thereafter, the court concluded that the *Cort v. Ash* analysis had rendered these theories obsolete. *See* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,895-899.

[165] *See id.* at 95,905-907.

[166] *Id.*; *see* Climan, *supra* note 158, at 208-18; Note, *Federal Margin Requirements as a*

incidental, and decidedly secondary importance was the protection that the margin requirements afforded investors.[167] More importantly, Congress imposed equal responsibility for margin violations on investors as well as brokers through the addition of section 7(f) in 1970.[168] This provision prohibits an investor from accepting any credit extended by a broker in violation of the margin regulations.[169] Judge Butzner, in a dissenting opinion, argued that section 7(f) should only be construed to prohibit implied private damage actions by investors who knowingly violate the margin regulation.[170] However, the majority refused to accept the proposition that Congress intended to protect investors while simultaneously imposing responsibility for violations of the statute on the same group.[171] Therefore, the court concluded that the plaintiff was not a member of the class entitled to assert especial rights under the statute.[172]

Addressing the second *Cort* inquiry, the *Stern* court found that the negative implications of the first *Cort* factor were determinative of the legislative intent. If Congress specifically did not intend to benefit the private investor by enacting section 7, Congress also did not intend to create a private enforcement action in favor of the investor.[173] In fact, Congress never directly considered the question of implied rights for margin violations.[174] Therefore, as the district court observed, the second factor in the *Cort* analysis is ambiguous.[175]

The Fourth Circuit interpreted the *Chris-Craft* decision as rephrasing the third *Cort* factor, the consistency of implication with the underlying legislative purpose, to include a determination of whether the implication

Basis for Civil Liability, 66 COLUM. L. REV. 1462, 1469 (1966); *Federal Margin Violations, supra* note 158, at 250-52.

[167] *See* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,906.

[168] *Id.* at 95,900-903. Section 7(f) of the '34 Act places equal responsibility for margin violations on the investor. The provision states in relevant part:

> It is unlawful for any United States person, or any foreign person controlled by a United States person or action on behalf of or in conjunction with such person, to obtain, receive or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited if it has been made . . . .

15 U.S.C. § 78g(f) (1976).

[169] *See* note 168 *supra.*

[170] Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,915 (Butzner, J., dissenting).

[171] Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc. [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,904-905.

[172] *Id.* at 95,907.

[173] *Id.*

[174] *See Federal Margins Violations, supra* note 158, at 253.

[175] Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,528 (D. Md. 1978) at 94,089.

was necessary to effectuate congressional goals.[176] Although the court acknowledged that the implication of private actions might aid in the enforcement of margin violations,[177] the court reasoned that only widespread violations posed a genuine hazard to the economy.[178] Thus, the *Stern* court concluded that SEC enforcement action would be a more efficient method of ensuring compliance than a multiplicity of private actions.[179] Additionally, the court noted that permitting margin violators to recover losses might actually encourage investors to engage in such activities.[180] Therefore, the *Stern* court concluded that the underlying legislative purposes militated against implying a private right of action under section 7.[181]

Finally, in addressing the fourth *Cort* factor, the *Stern* court acknowledged that implication of a private right under section 7 would not conflict with the traditional concerns of state law.[182] The court observed that margin violations alone would not form the basis for an actionable claim under state securities statutes.[183] However, the majority noted that Stern had alleged that the instant transactions contained elements of fraud which would be governed by state common law.[184] Thus, the court determined that the district court correctly dismissed Stern's claim for an implied federal right of action under section 7 of the '34 Act.[185]

Although section 7 does prohibit certain conduct, the statute fails to meet the *Redington* criteria for the implication of private rights. In *Chris-Craft,* the Supreme Court refused to characterize "a party whose previously unregulated conduct was purposefully brought under federal control" as the principal beneficiary of that statute.[186] Since section 7(f) now prohibits private investors from engaging in illegal margin trading, the *Stern* court similarly denied beneficiary status to the plaintiff. In addition, the express language of section 7(c) does not purport to create any damage rights or other remedy.[187] The *Stern* decision, therefore, is consistent with

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[176] Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,909; *see* text accompanying note 38 *supra.*

[177] Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,931 (4th Cir. July 16, 1979) at 95,909.

[178] The *Stern* court determined that only widespread margin violations could adversely effect the macro-economic conditions that Congress sought to control through the imposition of margin requirements. *Id.*

[179] *Id.*

[180] *Id.* The *Stern* court noted that by implying a private cause of action for margin violations in favor of investors, the investor was in a "no loss" situation. If his investments prospered, he reaped the rewards. If the investments soured, however, the investor could pass his loss on to the violating broker. *Id.*

[181] *See id.*

[182] *Id.*

[183] *Id.*

[184] *Id.*

[185] *Id.*

[186] Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 37 (1977).

[187] *See* Touche Ross & Co. v. Redington, 99 S.Ct. 2479, 2485 (1979).