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Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements

Morgan Shipman*

Because of recent court decisions and amendments to the Exchange Act, the question of implied private rights of action has become increasingly important. Professor Morgan Shipman presents an in depth discussion of two current implied rights problems. In part one, he addresses himself to the power of administrative agencies to negate implied private rights of actions by means of agency rules. Concerned over what such a power could do, he states that there appears to be no good reason why courts should manufacture for agencies a power to command the courts to relinquish their traditional independent jurisdiction over implied rights. In part two, the author discusses the implication by the courts of private rights of action under the Exchange Act for injuries arising out of violations of requirements of national securities exchanges and associations. He concludes that implication for violations of moderately specific requirements that are direct substitutes for SEC regulation would be beneficial in protecting the investor and in promoting reliance upon the self-regulators.

This article discusses two current questions relating to implied private rights of action under the Securities Exchange Act of 1934 (Exchange Act) 1. The first question concerns the authority of the Securities and Exchange Commission (SEC or Commission), the Comptroller of the Currency, and the other two agencies administering portions of the Exchange Act. Is an agency authorized to insert in one of its own rules implementing the act a provision negating an implied private right of action for a violation of the rule and the act 2 that would accrue but for the negation stipulation?

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This question can also arise in the administration of the other federal securities statutes under which private rights have been or may be implied, and the discussion in this article, although limited to the act, has some relevance concerning the negation authority under the other statutes.\(^3\)

The second question comes in two parts, the last part being closely related to the first question: (a) Should the courts imply a private right of action under the Exchange Act for injuries caused by violations of the rules and requirements of registered national securities exchanges, such as the New York Stock Exchange (NYSE), and of the National Association of Securities Dealers, Inc. (NASD), the self-regulatory organization for over-the-counter broker-dealers in securities; and (b) Do the self-regulatory organizations, the Commission, or both have the rule-making authority to negate any such rights the courts might imply? This second question is limited to the act because the other federal securities statutes\(^4\) do not affect the self-regulatory organizations so directly.\(^5\)

**PART I**

**AUTHORITY OF THE ADMINISTRATIVE AGENCY TO NEGATE**

I. **THE QUESTION AS POSED BY THREE RECENT DEVELOPMENTS**

The question is best posed by a summary of three events happening during the summer of 1964: the Supreme Court's decision

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2. Concerning recent activity on the antitrust front, see e.g., Kaplan v. Lehman Bros., TRADE REG. REP. (1966 Trade Cas.) § 71697 (N.D. Ill. Feb. 25, 1966) (complaint alleged antitrust laws prevent exchanges from fixing minimum commission rates, making the fixing illegal per se; court held Exchange Act obliquely gives exchanges power to fix rates and establishes procedure for review by the SEC, obviating need for application of antitrust laws); Jennings, *The New York Stock Exchange and the Commission Rate Struggle*, 53 CALIF. L. REV. 1119 (Dec. 1965).


5. Under the Investment Company Act of 1940, the National Association of Securities
in J. I. Case Co. v. Borak; the 1964 amendments to the Exchange Act; and the regulations issued on August 21, 1964, by the Comptroller of the Currency.

A. J. I. Case Co. v. Borak

On June 8, 1964, the Supreme Court handed down its unanimous decision in the case of J. I. Case Co. v. Borak. Borak was the first Supreme Court case considering implied private rights of action for violations of any of the federal securities statutes; and until the recent decision in Surowitz v. Hilton Hotels Corp., in which the Court in dictum appeared to endorse implied rights under the Exchange Act and the Securities Act of 1933 (Securities Act), Borak was the only such case passed upon by the Court. In Borak, the Court held that the Exchange Act impliedly authorizes a federal cause of action to be brought under section 27 for rescission or damages by a stockholder of a corporation which has participated in a consummated merger authorized pursuant to the use of a proxy statement alleged to contain false and misleading statements violative of section 14(a) of the Exchange Act and the proxy rules of the SEC.

The Court in Borak decided that the action could be asserted derivatively, that the federal court would have the power "to grant all necessary remedial relief," and that the overriding federal law rather than state law would, where the facts required, control the...
appropriateness of the redress.\textsuperscript{15} The Court was careful to point out that only allegations were before it and that questions of proof, causation, and remedy must await trial. In dictum, the Court indicated that state security-for-expenses statutes would not be applicable.\textsuperscript{16}

In reaching its conclusions, the Court said:

Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.\textsuperscript{17}

B. 1964 Amendments

On August 20, 1964, President Johnson signed the Securities Acts Amendments of 1964 (1964 amendments),\textsuperscript{18} the most important advance in federal securities legislation since 1940, when the Investment Company Act\textsuperscript{19} and the Investment Advisers Act\textsuperscript{20} were passed. The two principal effects of the 1964 amendments were to strengthen the regulation of securities broker-dealers and to extend to the security holders of some 4,000 larger over-the-counter companies the registration, periodic reporting, proxy solicitation, and insider trading protections of sections 12, 13, 14, and 16 of the Exchange Act.\textsuperscript{21} Generally speaking, these protections had previously been available only in listed companies. The 1964 amendments vested the jurisdiction to “administer and enforce” these provisions with respect to listed and over-the-counter banks with deposits insured under the Federal Deposit Insurance Act:\textsuperscript{22}

\textsuperscript{15} See note 14 \textit{supra}.
\textsuperscript{16} The court below held, following other decisions under the Act and other federal statutes, that such a state statute would not be applicable to implied private rights under the Act. See Borak v. J. I. Case Co., 317 E2d 838, 849 (7th Cir. 1963), \textit{aff’d}, 377 U.S. 426 (1964). That question was not raised in the petition for certiorari.
\textsuperscript{17} 377 U.S. 426, 432 (1964).
in the three federal bank regulatory agencies: (1) national and District of Columbia banks — the Comptroller of the Currency; (2) other member banks of the Federal Reserve System — the Board of Governors of the Federal Reserve System (FRB); and (3) all other insured banks — the Federal Deposit Insurance Corporation (FDIC).  

The vesting of jurisdiction in the bank regulatory agencies was a compromise adopted, without Commission opposition, to resolve the controversy concerning the coverage of banks in the bill. The banking agencies — with respect to the banks under their jurisdiction and the sections of the Exchange Act which they "administer and enforce" — have all the administrative, rule-making, and enforcement powers contained in any section of the Exchange Act. The 1964 amendments specify that the rules, regulations, and forms of the Commission are not binding upon the banking agencies in the execution of their functions. The Comptroller opposed the inclusion of banks, and especially banks under his jurisdiction, within the 1964 amendments. He argued that the inherent powers of his office and the FRB and the FDIC were sufficient and that any explicit legislative authority considered necessary should be added by amendments to the various banking acts.

C. Comptroller's Regulations

On August 21, 1964, the Comptroller of the Currency issued, under the general authority of the National Bank Act and under (and in implementation of) the portion of the Exchange Act administered by him, regulations applicable to national banks governing registration, periodic reporting, proxy solicitation, and insider trading — the four areas transferred to him by the 1964 amendments. The regulations were revisions of previous regula-

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23 See Phillips & Shipman, supra note 4, at 735-43; Comment, supra note 18.
24 See Phillips & Shipman, supra note 4, at 736.
27 See Phillips & Shipman, supra note 4, at 736 n.101.
29 See Phillips & Shipman, supra note 4, at 735-43; Comment, supra note 18.
30 Fed. Reg. 7676-78, 12300-05 (1964); Phillips & Shipman, supra note 4, at 742-43; Comment, note 18 supra. Although the only source of authority formally cited is the National Bank Act, the releases note that the revised rules also implement the
tions\textsuperscript{31} adopted under the general authority of the National Bank Act and carried forward sections stating that "enforcement . . . shall be the function solely of the [Comptroller] . . ." and that "no provision [of the implementing regulations] is intended to confer any private right of action on any stockholder or other person against a national bank."\textsuperscript{32} No reason for the adoption of the negation provisions was announced at either date.\textsuperscript{33} The regulations of the Commission, the FRB, and the FDIC do not contain similar declarations, outside of limited provisions discussed below.

The negation regulations — which have no explicit statutory authorization — purport, for example, to command a federal court, in a private action involving a solicitation by a national bank allegedly violating section 14(a) of the Exchange Act as implemented by the Comptroller's proxy rules, to disregard the Supreme Court's decision in \textit{Borak} and to pay no heed to the alleged violation. The regulations also attempt to negate implied rights under the general National Bank Act\textsuperscript{34} foundation for the various substantive requirements imposed by the Comptroller's rules.\textsuperscript{35}

\section*{II. A Brief Summary of Implied Rights}

The Comptroller has attempted to override the twenty-five years of experience of the federal courts in dealing with, shaping, and placing limits upon implied private rights,\textsuperscript{36} which exist in addition to the limited express private rights under sections 9(e), 16(b),

\textsuperscript{31} See also 12 C.F.R. § 10.1 (Supp. 1965), concerning registration under § 12 of the Act; 30 Fed. Reg. 6160 (1965); CCH FED. BANKING L. REP. § 94362 (item 11).

Miscellaneous amendments were made in 31 Fed. Reg. 6949-57 (May 12, 1966). The regulations, as revised, are stated to be under the authority of both the National Bank Act and the Exchange Act.


\textsuperscript{33} See materials cited notes 30-32 supra.


\textsuperscript{35} This article will not discuss the attempted restriction. Neither will it discuss the express or implied private rights for violations of requirements, similar to those under §§ 12, 13, 14, and 16 of the Exchange Act, imposed by state legislatures and insurance commissioners with respect to stock insurance companies, partially as a result of the 1964 amendments. See Phillips & Shipman, supra note 4, at 747-54; Comment supra note 18, at 1499-1505.

Advice by the Comptroller concerning the rights of a shareholder to obtain a shareholders list pursuant to the National Bank Act was disregarded in In Re Northeast Bancshares, Inc., 34 U.S.L. WEEK 2538 (N.Y. Sup. Ct. Mar. 23, 1966).

\textsuperscript{36} The first implied rights case apparently was Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876 (S.D.N.Y. 1941).
and 18 of the Exchange Act. Section 9(e) authorizes the recovery of damages by certain persons harmed by specified manipulative activities in listed securities. Section 16(b) allows a suit by or on behalf of listed companies and over-the-counter companies registered under section 12(g) of the act, added by the 1964 amendments, against an insider (officer, director, or ten per cent shareholder) for recovery of certain types of short-swing profits in the trading of the company's equity securities. Section 18 relates to persons making false or misleading statements in applications, reports, or documents filed pursuant to the act. The section creates a right of action against those persons in favor of purchasers or sellers who deal in a security at a price affected by the statement, rely upon the statement, and thereby suffer damage. Section 18 excuses from liability a defendant showing that he acted in good faith and without knowledge that the statement was false or misleading.

The federal courts - rejecting expressio unius arguments based on the presence of sections 9(e), 16(b), and 18 - have also implied private rights of action in favor of investors and other parties injured by violations of several provisions of the Exchange Act and agency rules thereunder. Private actions for violations of


The question whether a degree of scienter is required in private Rule 10b-5 actions (see note 52 infra and accompanying text; 3 Loss, op. cit. supra note 3, at 1766-71) to some extent grows out of the relationship of Rule 10b-5 actions by purchasers to actions under the Securities Act. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964).
section 14(a) and the proxy rules (where injunctive actions have also been frequent) and section 10(b) (still administered by the Commission with respect to all bank and other securities) and Rule 10b-5 have been the most numerous. Rule 10b-5, of course, prohibits — in connection with any purchase or sale of any security by any person in which the mails or facilities of interstate commerce are used — schemes to defraud, statements which are false or misleading or half-truths, and acts, practices, and courses of business which operate or would operate as a fraud. Several other sections of the Exchange Act have also been involved.

Implied rights have been furnished several protections and advantages because of the structure of the Exchange Act. Since implied rights have been considered as arising under the act, private plaintiffs have been allowed to use the liberal venue and service of process provisions of section 27. In Borak, the Court based, in part, the implication of the right upon the section, which gives the federal courts exclusive jurisdiction of actions brought to enforce any liability or duty created by the Exchange Act or agency rules

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42 Phillips & Shipman, supra note 4, at 739-41.


thereunder.\textsuperscript{47} Section 28(a)\textsuperscript{48} states that the rights and remedies provided by the Exchange Act are in addition to all others that may exist "at law or in equity" and that nothing in the act affects state regulation insofar as it does not conflict with the act or rules thereunder. Section 29(a)\textsuperscript{49} voids any provision binding any person to waive compliance with the Exchange Act or any rule.

On the other hand, implied rights under the Exchange Act are subject to many of the usual defenses and limitations. The courts have applied state statutes of limitations and traditional liability-limiting requirements of causation have been imposed; other limitations such as estoppel and laches may also sometimes be applicable.\textsuperscript{50} The right of any person permitted under the Exchange Act to sue for damages is limited by section 28(a) to a total recovery — whether in one or more actions — of his "actual damages on account of the act complained of."\textsuperscript{51} Two of the most interesting current issues center around whether a degree of scienter is re-
quired in Rule 10b-5 actions and the Commission's complaint in the case of SEC v. Texas Gulf Sulphur Co.\textsuperscript{52}

The issue dramatically posed by the Comptroller's attempt to erase implied rights for violations of his rules is fundamental and important. It is fundamental as it involves the inherent power of an agency to oust the courts from their traditional role in determining when and what types of private relief should be granted for violations of the Exchange Act. It is important because implied private rights have become more important under the Exchange Act than the express liabilities. Before turning to a discussion of the power of an agency to negate, it may be helpful to note some preliminary points and to discuss the two sources of implied private rights: section 29(b)\textsuperscript{53} and the statutory tort doctrine.

III. SOURCES OF IMPLIED RIGHTS

A. Some Preliminary Points

Under the structure of the Exchange Act, a violation of an agency rule is nearly always a direct violation of the statute, for the substantive portions of the act either make unlawful the failure


Contrary to the statement in Trussell v. United Underwriters, supra, a showing of a criminal violation is not necessarily required in a Rule 10b-5 action. Section 10(b) itself makes unlawful the violation of Rule 10b-5, and the tort doctrine is not limited to criminal violations. In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), for example, the Court did not pin its result to a criminal violation, which under § 32(a) would require a showing of willfullness. Section 29(b) refers to violations, not willful violations.

Relationship of Rule 10b-5 actions by purchasers to actions under the Securities Act also enters the picture, in which respect § 32(a) is relevant. Also involved is the question of the Commission's power under § 10(b). See, e.g., Ellis v. Carter, supra. Liability for negligent misstatements is analyzed in Comment, Negligent Misrepresentations Under Rule 10b-5, 32 U. CHI. L. REV. 824 (1965).


to comply with implementing rules or directly require observance of the rules. For example, conduct violating the Comptroller's proxy rules also directly violates section 14(a) of the Exchange Act, the source of his power in the act to issue proxy rules. However, although the Comptroller's negation rules explicitly attempt only to negate private rights for violations of the implementing rules, the plain intent is also to erase implied private rights for the violations of sections of the statute that become operative solely through an implementing rule.

The deviation from the rules of the Commission, the FRB, and the FDIC in the negation rules of the Comptroller is probably not itself fatal. The Comptroller's substantive rules differ in many ways from the Commission's and those of the FRB and the FDIC, which are similar to those of the SEC. For example, the Comptroller's proxy rules do not expressly prohibit false and misleading statements, an omission which may have also been designed to avoid Borak, but which may have little effect because the prohibition is easily implied. The legislative history of the 1964 amendments quite directly states that a bank agency may adopt rules different

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85 The negation rules do not purport to contract the statutorily created § 16(b) liabilities, although some of the Comptroller's other rules do provide exemptions from the section. See 12 C.F.R. § 12.5(b) (Supp. 1965). The negation rules also seemingly do not attempt to limit implied private rights under § 16(a), which directly requires insiders to report all transactions. On implied private rights under § 16(a), see Chicago So. S. & So. B. R.R. v. Monon R.R., CCH FED. SEC. L. REP. ¶ 91525 (N.D. Ill. 1965) (suit by management to compel filing by outside purchaser); Kroese v. Crawford, CCH FED. SEC. L. REP. ¶ 91262 (1961-1964 Transfer Binder) (S.D.N.Y. 1963) (shareholders action to compel filing).

12 C.F.R. § 10.2, as revised in 31 Fed. Reg. 6949-57 (May 12, 1966), clearly does not attempt to affect implied rights under § 16(a). At the present time, the Comptroller's rules, as revised, supra, contain a number of exemptions from § 16(b).


from the Commission’s when the agency deems it appropriate. Under this permission, the omission of a prohibition against false and misleading statements, whatever its effect, is not inconsistent with the Exchange Act solely because the Commission’s rules have an explicit prohibition. The deviation in the negation rule seems to stand on much the same footing. If negation rules are sanctioned, the difference in opinion is seemingly not fatal, although the vast divergence here involved may be given some weight.

The Comptroller, it should be noted, is not entirely a pioneer in attempting to negate implied rights. At one time, the Commission’s proxy rules declared that noncompliance with them would not invalidate any proxy pursuant to which action had been taken. This was deleted in 1940 on the ground that “the legal consequences of noncompliance . . . are for determination by the courts.” At present, Rule 17a-8, which requires the reporting by exchanges of proposed changes in their rules three weeks before adoption, states that a failure to file as required “shall not affect the validity, force or effect of any rule of the exchange or of any exchange action or omission to act thereunder.” Furthermore, the Commission’s proposed reporting rules for foreign issuers attempt to remove from the express private rights under section 18 certain registration statements and periodic reports to be required under sections 12(g) and 13. The Comptroller’s negation rules also apparently attempt to eliminate section 18 liability but not the express rights under section 16(b) or implied rights flowing from the language of section

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68 See § 12(i); CCH FED. BANKING L. REP. § 94362 (item 11); Phillips & Shipman, supra note 4, at 736 n.101, 741-43.

69 See discussion and materials cited in Phillips & Shipman, supra note 4, at 737-38 n.105.

60 17 C.F.R. § 240.17a-8 (1964).

61 In the 1950’s the Commission proposed to promulgate rules under section 14(b) concerning the voting by broker-dealers of street name securities. The proposed rules stated that once a proxy was executed, the broker-dealer’s noncompliance would not invalidate the proxy. See Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 COLUM. L. REV. 12, 26-27 (1966).


Presumably, the Comptroller's negation rules would not foreclose him from attempting to obtain recoveries — as the Commission is attempting to do in the *Texas Gulf Sulphur case* — for private parties in the form of relief ancillary to his court enforcement actions.


The negation rules do attempt to void implied rights for violations of § 13. Concerning implied rights for such violations, see Kroese v. Crawford, CCH FED. SEC. L. REP. (Transfer Binder, 1961-64) ¶ 91262 (S.D.N.Y. 1963); Jaypen Holdings, Ltd. v. Bellanca Corp., 27 F.R.D. 190 (D.N.J. 1958). If the alleged violation is a false or misleading statement in a report or other paper (rather than a complete omission, a failure to file, or a late filing), § 18 should seemingly control. Cf. materials cited note 68 *infra*.

The discussion of the authority to negate implied rights and the text accompanying notes 123-25 *infra* are applicable here, and an agency attempt to exempt from § 18 seems to rest on even weaker grounds than an attempt to override § 29(b). One approach used in the exemption in the Commission's proposed foreign securities rules (see note 63 *supra*) is to declare that required documents will not be deemed "filed" with the Commission. This approach appears futile on a literal basis, for §§ 12(g), 13, and 15(d), under which the implementing rules will be issued, require "filing" of — or state that the company "shall file" — registration statements, reports, and documents. The Commission's power to define technical, trade, and accounting terms (Exchange Act § 3(b), 48 Stat. 882 (1934), as amended, 15 U.S.C. § 78c(b) (1964), does not seem nimble enough to allow it to define away its statutory base of power for one purpose and retain the base for another. Would the result be different if a conditional exemption from § 12(g) were allowed? See text accompanying note 112 *infra*.

The exemption in Rule 14a-3, 17 C.F.R. § 240.14a-3 (1964) stands on firmer footing, as § 14(a) is the source of authority. See, however, Phillips & Shipman, *supra* note 65, at 790; note 68 *infra*.

In dealing with certain types of American Depositary Receipts registered under the Securities Act, the Commission has attempted a similar limitation of liability. See 1 LOSS, *op. cit. supra* note 52, at 465; Phillips & Shipman, *supra* note 65, at 759.
10b-5, just as the Comptroller's attempt to overturn Borak in the proxy area may, if successful, be an invitation to an extension of Rule 10b-5 to many solicitations by national banks. Furthermore,

Section 18 requires that the plaintiff show reliance and a purchase of the security at a price influenced by the false statement. The section provides the defendant a defense if he shows action in good faith and without knowledge of the false statement. Although Rule 10b-5 actions require reliance (see Painter, supra note 50), the other obstacles to recovery contained in § 18 may not be present in Rule 10b-5 cases.


May an action be brought under Rule 10b-5 when the paper containing the statement complained of is subject to § 18? In Miller, judgment on this question of overlap was reserved.

The Comptroller's negation rules cannot contract Rule 10b-5. See note 42 supra and accompanying text; but cf. note 69 infra. The Commission's rules attempting to excuse companies from § 18 liability do not, in terms, also purport to negate Rule 10b-5 liability, but they could be considered (despite the Commission's intimate acquaintance with civil liabilities under Rule 10b-5) as necessarily attempting to include such an exemption.

The Commission's view is that if there is overlap in the authority retained by it over the trading of bank securities and the authority transferred to the bank agencies, each agency has authority to act, and the rules of each are applicable. See Phillips & Shipman, supra note 65, at 739-41. If so, Rule 10b-5 would not be restricted because one of the bank agencies also has proxy rules governing solicitations. Yet, the courts might hold that where the bank agency has applicable proxy regulations under the Act, Rule 10b-5 would not be applied to proxy solicitations subject to the bank agency's rules. A court taking that attitude might, however, hold differently if the Comptroller's negation rules were upheld or if it were held that the failure of the Comptroller's rules explicitly to prohibit false and misleading statements has effect.

Rule 10b-5 would in any event be applicable to a proxy solicitation only if one of the matters to be voted upon concerned the purchase or sale of a security — for example, a merger or a stock option plan. Though there should be no question, it is not clear whether Rule 10b-5 could be applied to mergers. H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960) held that Rule 10b-5 could be applied to certain types of mergers. See also Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965). In Borak v. J. I. Case Co., 317 F.2d 838, 846-47 (7th Cir. 1963), aff'd, 377 U.S. 426 (1964), both lower courts had taken a dim view of the possible applicability of Rule 10b-5 to the solicitation concerning the merger. For other cases casting doubt on the application of Rule 10b-5 to mergers, see Vine v. Beneficial Fin. Co., CCH Fed. Sec. L. Rep. § 91634 (S.D.N.Y. Feb. 23, 1966); SEC v. National Sec., Inc., CCH Fed. Sec. L. Rep. § 91646 (D. Ariz. Feb. 14, 1966); Elfenden v. Yaeger, CCH Fed. Sec. L. Rep. (Transfer Binder, 1961-64) § 91368 (S.D.N.Y. 1964); Sawyer v. Pioneer Mill Co., 190 F. Supp. 21 (D. Hawaii 1960), appeal dismissed as moot, 300 F.2d 200 (9th Cir.), cert. denied, 371 U.S. 814 (1962). This uncertainty is probably due to the Commission's Rule 133 under the Securities Act, spelling out a no-sale exemption from Securities Act § 5. Rule 133 is discussed in 1 Loss, op. cit. supra note 52, at 518-42.

Rule 10b-5 and § 14(a) were relied upon by the plaintiff in Simon v. New Haven Board & Carton Co., 250 F. Supp. 297 (D. Conn. 1966), a derivative action based on allegations of damage through approval of a merger by shareholders relying on false and misleading reports and proxy statements. The court, on a motion to dismiss, held an action was stated under Rule 10b-5, finding it unnecessary to consider § 14(a).
the good-faith-reliance immunity of section 23(a)\(^{70}\) is probably inapplicable.\(^{71}\)

**B. Section 29(b)**

The attempted negation of implied rights — which have been based upon section 29(b)\(^{72}\) and the statutory tort doctrine, bases which often, but not always, overlap — raises more difficult issues. In addition to the express private rights created by sections 9(e), 16(b), and 18, the Exchange Act provides an almost-express private cause of action in section 29(b), although rights under section 29(b) are most often discussed in the "implied" classification. Section 29(b) states that every contract made in violation of the Exchange Act or any rule thereunder, or the performance of which involves the violation of such act or any rule thereunder, is void. The contract is void, however, only as it regards the rights of the violator or any successor to the contract taking with actual knowledge of the facts constituting the violation. Section 29(b) is applicable only if there is privity of contract\(^{73}\) and thus complements sections 9(e), 16(b), and 18, which furnish private remedies in three situations where the plaintiff will seldom be in privity of contract with the defendant.

Although section 29(b) was not extensively discussed during the congressional hearings and debates on the Exchange Act, there was some recognition of the effect of the section upon the rights and liabilities of private parties.\(^{74}\) Furthermore, during the congression-

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\(^{71}\) See notes 174-79 infra and accompanying text.


\(^{73}\) See 3 Loss, op. cit. supra note 52, at 1759.

\(^{74}\) In both original bills, the forerunner of § 29(b) would literally have voided the contract rights of innocent as well as violating parties. See § 27(b) of the original bills, reprinted in Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852, 8720, 73d Cong., 2d Sess. 14-15 (1934) [hereinafter cited as 1934 House Hearings]; 15-16 Hearings Before the Senate Committee on Banking and Currency on Stock Exchange Practices, 73d Cong., 2d Sess. 6435 (1934) [hereinafter cited as 1934 Senate Hearings]. Concern over this effect on the rights of private parties led to the adoption of a Senate floor amendment to save the contract rights of innocent parties. See 78 CONG. REC. 8593 (remarks of Senator Hastings), 8600-01 (1934). This change carried through to enactment. See H.R. REP. NO. 1838, 73d Cong., 2d Sess. 37-38 (1934). Neither original bill contained language similar to that in § 29(c) of the act, which provides further protections against the voiding of certain loans and liens made or created in good faith. During the congressional consideration, a group of businessmen attacked, among other things, the language of the forerunner of § 29(b). They noted its potential adverse effects upon the contract rights of innocent
al hearings on the 1938 amendments\textsuperscript{76} to the Exchange Act, section 29(b) — and implied rights — were focused upon. Provisos added at that time to section 29(b) excluded from the section contracts in violation of rules under two newly added sections of the Exchange Act and inserted a special short statute of limitations for actions based upon alleged violations of rules under section 15(c)(1)\textsuperscript{76} — a general antifraud section authorizing Commission rules in respect of over-the-counter transactions of broker-dealers.\textsuperscript{77}

Courts have often used section 29(b) in implying a remedy. For example, in \textit{Kardon v. National Gypsum Co.},\textsuperscript{78} the landmark case implying rights for violation of Rule 10b-5, the court felt that “a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute [section 29(b)] would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences.”\textsuperscript{79} The court interpreted the provisos added in 1938 as contemplating that Congress intended the original section 29(b) to be interpreted as authorizing civil suits for rescission or money damages under it.\textsuperscript{80}

C. Statutory Tort

The second basis for implied rights has been the statutory tort doctrine, which states that in the absence of legislative intent to the contrary, civil remedies will be (or may be) afforded for injuries caused by violation of a statute, to members of the class of persons the statute is intended to protect.\textsuperscript{81} This doctrine has been primarily

\textsuperscript{75} See materials cited in 3 Loss, \emph{op. cit. supra} note 52, at 1760 n.253.


\textsuperscript{77} See materials cited in 3 Loss, \emph{op. cit. supra} note 52, at 1760 n.253.


\textsuperscript{79} Id. at 514.

\textsuperscript{80} \textit{Ibid.} Professor Ruder, \textit{Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent}, 57 NW. U.L. REV. 627 (1963), interprets the 1938 amendments as recognizing a private right of action only for violation of § 15(c)(1) rules.


\textit{Kardon} relied upon § 286 of the Restatement of Torts. Interestingly, the Restate-
applied to violations of Rule 10b-5 and the proxy rules, but it has also been applied to violations of various other provisions of the Exchange Act, other federal securities statutes, and several federal statutes outside the securities field. This doctrine, of course, has long been applied in negligence actions. The tort doctrine can operate wherever section 29(b) may be applicable, but unlike section 29(b), can furnish remedies in the absence of privity of contract between the plaintiff and the violator. In fact, the two bases are often merged by the courts.

Although the Supreme Court in *Borak* did not extensively discuss the theoretical foundation of the implied right there involved, the statutory tort doctrine was clearly one primary basis. The Court did not mention section 29(b), perhaps because of the lesser flexibility that it might provide in dealing with the difficult question of the appropriate remedy (the merger was consummated in 1957) if a violation of section 14(a) were shown on remand. The Court examined the legislative history of section 14(a), noting first the congressional belief that fair suffrage should attach to listed securities, and second the congressional findings in 1934 that proxies were too often solicited with inadequate disclosure. The Court discussed the broad, remedial purposes of section 14(a), as evidenced by the wide discretion given the agency to adopt proxy solicitation rules as "necessary or appropriate in the public interest or for the protection of investors," and the statutory declaration that violation by any person of the rules is "unlawful." The Court then decided that while section 14(a) "makes no specific reference to a private right of action, among its chief purposes is the protection of in-

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83 2 Harper & James, Torts § 17.6 (1956); Prosser, Torts § 35 (3d ed. 1964).

84 See 3 Loss, op. cit. supra note 52, at 1757-61; note 68 supra.


87 The application of § 29(b) where a proxy solicitation has violated § 14(a) presents two questions. Are the proxies contracts? If the proxies are to be voided, may a further contract (a merger agreement, for example) approved pursuant to the proxies also be voided under § 29(b)? These questions are bypassed if the tort doctrine is applied.


90 Id. at 431-32.
vestors,' which certainly implies the availability of judicial relief where necessary to achieve that result."

Another ground upon which the Court placed its decision was the helpful supplement to Commission action supplied by private enforcement of the proxy rules, the Court making an analogy to antitrust treble damage litigation. Apparently, therefore, this aid must be considered in determining whether to imply private rights. Finally, the Court said that under the circumstances before it, "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."

The Commission has rather consistently asked the courts to extend implied private rights under the Exchange Act, on the grounds that private enforcement aids its action. A primary jurisdiction doctrine has seldom been urged by the Commission, which is not surprising in light of the absence of administrative authority to award damages or other private relief for violations of the Exchange Act, and the fact that often the Commission's only means of enforcement is an application for injunctive relief. Section 26, furthermore,

90 Id. at 432.
91 See also Hewitt-Robins, Inc. v. Freight-Ways, Inc., 371 U.S. 84 (1962). This was a common law action against a carrier for misrouting. On reference to the ICC, that body had held the carrier's alleged action unreasonable. The majority of the Court held that a cause of action was stated, that the cause of action was not extinguished by the federal statute and that allowing misrouting actions would be fair and would have a healthy deterrent effect upon misrouting practices, which in turn would minimize cease and desist proceedings before the ICC.
93 The Commission in 1947 stated that a private plaintiff in an action under the proxy rules should take his complaint first to the Commission. See 2 Loss, op. cit. supra note 52, at 952-54. This is common in those cases, although the Commission's only enforcement route, if it decides to act, is a request for injunctive relief. In Standard Fruit & S.S. Co. v. Midwest Stock Exch., 178 F. Supp. 669 (N.D. Ill. 1959), the court held that primary jurisdiction did not preclude it from granting relief requested by a company to enjoin an exchange's trading in its securities on an unlisted basis and without authorization under Exchange Act § 12 (f), 48 Stat. 892 (1934), as amended, 15 U.S.C. 78l(f) (1964), although the Commission has pervasive powers over unlisted trading and could have terminated the trading in question. The courts and the Commission have concurrent jurisdiction to determine questions of "control," as defined in § 2(a) (9) of the Investment Company Act, 54 Stat. 750 (1940), 15 U.S.C. § 20a-2 (a) (9) (1964). See, e.g., Willheim v. Murchison, 342 F.2d 33 (2d Cir.), cert. denied, 382 U.S. 840 (1965).

A noteworthy recent case concerning the primary jurisdiction doctrine and suits by private parties under Rule 10b-5 is Fischer v. Kletz, CCH FED. SEC. L. REP. § 91687 (S.D.N.Y. Jan. 13, 1966). The court held the doctrine did not preclude it from proceeding in the case, although the ICC was also concerned. Cf. Klastorin v. Roth, 353 F.2d 182 (2d Cir. 1965).


states that action or inaction by the agency shall not be construed as approval of any security or transaction therein and that agency action or inaction on a statement or report is not a finding that the statement is true and accurate on its face.\footnote{1966} 

It is against the background of section 29(b) and the statutory tort doctrine that the rule-making authority must be measured.

### IV. The Rule-Making Powers of the Agencies

Before matching the agencies' exemptive and general rule-making authority against section 29(b) and the statutory tort doctrine, it may be useful to examine the agencies' powers in some detail.

A negation authority can probably be constitutionally delegated to an agency,\footnote{1966} and Congress may have indirectly delegated that dis-

\footnote{§ 78s(a) (1964); Exchange Act § 15A, 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3 (1964), Commission administrative disciplinary proceedings can be brought against broker-dealers, exchanges, and registered securities associations that do not comply with the Act and the Commission's rules. On the other hand, if a broker-dealer or exchange is not involved, enforcement of § 14 and Rule 10b-5, perhaps the two most important requirements of the act, is available only through applications for injunctive relief or criminal references, although the Commission has the standard investigative and administrative subpoena powers.}

In the 1964 amendments, the agencies were given new authority to conduct administrative hearings and issue orders requiring compliance with several sections of the statute; however, such orders require court enforcement. See Phillips & Shipman, supra note 65, at 778-81. Statutory authorization to institute an administrative proceeding does not limit the agency's right to request injunctive relief. ibid.

In Silver v. New York Stock Exch., 373 U.S. 341 (1963), the Court considered, \textit{inter alia}, the possible incompatibility of the objectives and duty of exchange self-regulation with the maintenance of an antitrust action. Concerning primary jurisdiction and the antitrust statutes, see materials cited note 2 supra.

\footnote{§ 78z (1964).}

\footnote{§ 78z (1964).}


\footnote{Securities Act § 23, 48 Stat. 87 (1933), 15 U.S.C. § 77w (1964) is similar.}

\footnote{Congress can itself negate implied rights. Section 29(b) can be restricted, as it is in certain respects, and the tort doctrine cannot operate in the presence of strong negative intent. By committee report language, Congress negated implied rights in one area of the 1964 amendments. See Phillips & Shipman, supra note 65, at 754-55. See also Joseph, supra note 44, at 176-77.}

\footnote{The constitutionality of the act and its delegations of rulemaking powers has been upheld, whenever challenged. See R. H. Johnson & Co. v. SEC, 198 F.2d 690 (2d Cir.), \textit{cert. denied}, 344 U.S. 855 (1952); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), \textit{cert. denied}, 321 U.S. 786 (1944); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), \textit{cert. denied}, 320 U.S. 751 (1943); 2 Loss, \textit{op. cit. supra} note 52, at 871.}

\footnote{Congress has delegated powers to the agencies to provide exemptions from § 16(b), an express liability section. See Smolowe v. Delendo Corp., supra; note 125 infra; notes 174-79 infra and accompanying text.}

\footnote{Furthermore, as discussed below, there may be circumstances where it arguably would at least be desirable for the agency to have the power, subject to intensive judicial review.}

\footnote{A cause for concern does come from the cases holding that a legislative body cannot delegate to an agency the power to determine whether the violation of a regulation will}
cretion to the Commission in two areas of broker-dealer regulation. However, nothing in the Exchange Act or its legislative history spells out or clearly implies an agency power to negate implied rights by rule or by order.

If there is any serious constitutional question, it may create a presumption against inherent power in the agency or implied delegation. Cf. id. at 72-73; Smolowe v. Delendo Corp., supra.

One analogy is furnished by the wage control legislation during World War II and the Korean War allowing the President to prescribe the extent to which wage payments in excess of those specified under the statute should be disregarded by governmental agencies in determining the allowable costs of the employer for purposes of other laws or regulations. Exercise of this authority to disallow deductions or inclusions in cost of goods sold under the Internal Revenue Code led to constitutional challenge — but not on grounds of unduly broad delegation. Rather, the constitutional challenge was to the authority of Congress to levy the tax without allowing the taxpayer the benefit of the deductions or inclusion in cost of goods sold. For cases involving challenges (unsuccessful) to the Korean War legislation, see Pedone v. United States, 151 F. Supp. 288 (Ct. Cl.), cert. denied, 355 U.S. 829 (1957); Sidney Zehman, 27 T.C. 876 (1957), aff'd per curiam, 253 F.2d 424 (6th Cir. 1958).

If the Act's rulemaking jurisdiction of the Commission, the exchanges, and the National Association of Securities Dealers, Inc. also overlap. If no implied private rights of action under the Act result from violations of the rules and requirements of the self-regulators — a question discussed in part II of this article — the Commission often can determine whether implied private rights under the act will flow from regulation.

As also discussed in part II, there may be some doubt whether violations of § 15(b) (10) rules create implied rights.

In the version of the 1938 amendments reported by the Senate Committee, the applicability of § 29(b) to contracts made in violation of certain rules would have been forbidden unless the Commission provided otherwise. S. REP. No. 1455, 75th Cong., 3d Sess. 10-11 (1938). See also 3 Loss, op. cit. supra note 97, at 1760 n. 253. In the bill as reported by the House Committee and as enacted, the proposed discretionary authority was removed and several other changes were made. This proves nothing. Without clear authority, an agency cannot move into § 29(b) what Congress has excluded.
The agencies administering the Exchange Act have great flexibility in establishing what is required in the way of reporting and proxy solicitation practices. Congress delegated flexibility so that the agency would be vested with "power to eliminate undue hardship and to prevent and punish evasion."100

Most of the sections of the Exchange Act imposing duties on broker-dealers, companies, and others either (1) state that it shall be unlawful to do or fail to do certain things in violation of implementing agency rules, or require adherence to such rules, (2) specify the outer limits of the rules an agency may adopt, or (3) declare the congressional purposes and set the standard under which the agency is to work in adopting rules — usually public interest or for the protection of investors.101 Most sections, therefore, have force only to the extent the agency adopts implementing rules. Section 23(a)103 empowers each agency "to make such rules and regulations as may be necessary for the execution of the functions vested in them by [the Exchange Act], and . . . for such purpose [to] classify issuers, securities, exchanges, and other persons or matters within their respective jurisdictions."104 Several sections — including section 12(h), added by the 1964 amendments — also allow, under stated general standards, the agency to remove companies and persons, or classes thereof, from certain substantive sections of the Exchange Act — including sections 12(g), 13, 14, and 16.105

The validity of a negation order turns on the same considerations as does the validity of a negation rule; negation orders are thus not separately discussed.

101 See Baird v. Franklin, 141 F.2d 238, 244 n.4 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
102 Note, however, that in Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), Judge Clark found that violations of two sections of the act seemingly required implementing regulations for effectiveness, although neither section at the relevant dates had been so implemented.
104 Exchange Act §§ 12(g), (h), 48 Stat. 892 (1934), as amended, 15 U.S.C. §§ 78l(g), (h) (1964), also contain classification authority.
can be done in whole or in part, on terms and conditions, and for limited periods.

Whenever the statute uses "technical, trade, and accounting terms," the agency may, under section 3(b), define them by rule "insofar as such definitions are not inconsistent [with the Exchange Act]." The legislative history indicates that the definitions will stand so long as they are not "clearly inconsistent with the legislative intent."  

The agency's discretion in shaping its rules and in providing exemptions can affect civil liabilities in several ways. The agency can, acting within the standards set by the Exchange Act, set modest requirements for companies and other persons subject to its jurisdiction, and that action would be beyond challenge in court. The Commission's proxy rules also, validly it would seem, relieve management and the issuer of liabilities for the contents of insurgents' materials mailed by the issuer and of shareholders' statements included in management's proxy statement if the mailing or inclusion is required by the rules. Furthermore, section 12(h) allows the agency, if the applicable general standards are met, to exempt companies and persons from sections 12(g), 13, 14, and 16 by order or by rule. The agency may thus be empowered, in some cases, to provide retroactive exemptions from these sections and by eliminating violations of the act, also provide immunity from civil liability. Lastly, if a conditional exemption from a section of the stat-

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107 Other definitional powers are found in § 12(g) (5). See Phillips & Shipman, supra note 105, at 724, 730.
109 See 2 Loss, op. cit. supra note 97, at 913-15.
110 See materials cited note 105 supra.
111 The Commission has provided retroactive exemptions under the Investment Company Act. 3 Loss, op. cit. supra note 97, at 1760 n.253. Several of the Commission's rules providing exemptions from § 16(b) have been retroactive. See, e.g., the prior version of Rule 16b-9 (SEC Securities Exchange Act Release No. 7118, August 19, 1963), upheld in Max Factor & Co. v. Blau, CCH Fed. Sec. L. Rep. ¶ 91359 (S.D. Cal. 1964), aff'd, 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965). In its most recent rules providing exemptions from § 16(b), the Commission proposed, and decided against, making the liberalizing amendments retroactive. SEC Securities Exchange Act Release No. 7826, February 17, 1966. There apparently can be no good faith reliance, within the meaning of provisions such as Exchange Act § 23(a), 48 Stat. 901 (1934), as amended, 15 U.S.C. § 78w(a) (1964) on the retroactive portion of an invalid exemption. Cf. text accompanying notes 174-79 infra. Section 23(a) and similar protections in other federal securities statutes are discussed in 3 Loss, op. cit. supra note 97, at 1842-49.
ute is provided, a violation of the conditions may not be a violation of the statute.\textsuperscript{112}

Three sections, 12(h), 3(a)(12)\textsuperscript{113} and 16(b), authorize exemptions from the express private right created in section 16(b),\textsuperscript{114} although no comparable sources exist with respect to sections 9(e) and 18.\textsuperscript{115} Section 16(b), it should be pointed out, makes nothing illegal or unlawful; and in determining whether the acts referred to in the section create civil liability, it is, generally speaking, immaterial whether a section of the Exchange Act has been violated.\textsuperscript{116} If there is a cause of action under section 9(e) or 18, a violation of another section of the statute will necessarily be present.\textsuperscript{117}

Of the three sections furnishing power to exempt from section 16(b), section 12(h) has already been mentioned.\textsuperscript{118} Section 3(a)(12) authorizes exemptions, as the agency deems necessary or appropriate in the public interest or for the protection of investors, of "securities" from section 16 and certain other sections.\textsuperscript{119}

\textsuperscript{112}The exemption may be drafted so that a failure to meet the conditions automatically subjects the person to the statute or an implementing rule. When the exemption is from $§\ 12(g)$ (which requires certain over-the-counter companies to register and thus become subject to §§13, 14, and 16), there is an interesting question whether a violation of the conditions would automatically cause the company to be subject to §§13, 14, and 16. See Phillips and Shipman, supra note 105, at 722-23.


\textsuperscript{115}Exchange Act $§\ 9(e)$, 48 Stat. 889 (1934), 15 U.S.C. $§78i$ (1964); Exchange Act $§\ 18$, 48 Stat. 897 (1934), as amended, 15 U.S.C. $§78r$ (1964). The agencies have considerable control over the papers required to be filed under the act and by requiring or not requiring papers, potential §18 liability is affected. Sections 3(a)(12) and 9(f) combine to give the Commission authority to exempt from §9(a); §§9(b) and 9(c) are operative only as implemented by Commission rules. This authority affects potential liability under §9(e). It is also possible, though seemingly unlikely, that §§3(a)(12) and 9(f) combine to give the Commission authority to exempt violations of §§9(a)-(c) from §9(e).

\textsuperscript{116}See 2 Loss, op. cit. supra note 97, at 1040-44. Some cases have, however, in borderline areas looked to subjective factors in determining whether a person is an insider and whether there has been a "purchase" or a "sale" and in computing profit. See, e.g., Blau v. Lehman, 368 U.S. 403 (1962); Heli-Coil Corp. v. Webster, CCH Fed. Sec. L. Rep. $§91578$ (3d Cir. 1965); Max Factor & Co. v. Blau, CCH Fed. Sec. L. Rep. $§91359$ (S.D. Cal. 1964), aff'd, 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965). This willingness, which appears to be increasing, may be partially attributable to the improving efficacy of Rule 10b-5 to handle actual misuse of inside information.

\textsuperscript{117}Section 9(e) is triggered by willful violations of §§9(a)-(c). As to §18, see note 57 supra and Exchange Act $§\ 32(a)$, 48 Stat. 904 (1934), as amended, 15 U.S.C. $§78ff(a)$ (1964).

\textsuperscript{118}See text accompanying notes 104-05 supra.

\textsuperscript{119}This authority played a significant role in Kornfeld v. Eaton, 217 F. Supp. 671 (S.D.N.Y. 1963), aff'd, 327 F.2d 263 (2d Cir. 1964).
16(b) removes from its operation "any transaction or transactions which [the agency] by rules and regulations may exempt as not comprehended within the purpose of this subsection."\(^{120}\)

It is the exemptions from section 16(b) that have, to date, tested the Commission's exemptive powers. The validity of the pre-1960 version of Rule 16b-3,\(^{121}\) which entirely exempted from section 16(b) many purchases of stock under restricted stock option and certain other employee plans, was seriously questioned by several courts;\(^{122}\) one court declared it invalid.\(^{123}\) The Commission's 1960 revision contracted the exemption. The Second Circuit has upheld Rule 16b-6, which is more limited than the pre-1960 version of Rule 16b-3.\(^{124}\) In reviewing rules providing exemptions from section 16(b), the courts have often made a searching independent inquiry to determine whether the rule is consistent with the purposes of the Exchange Act.\(^{125}\)

V. THE RULE-MAKING POWERS AND SECTION 29(b)

When these general rule-making powers are matched against the self-executing language of section 29(b),\(^{126}\) an agency hoping that its negation rule will erase implied rights flowing from that section will find little comfort. The section specifies in plain terms an effect of the violation of any rule or any section of the Exchange Act. Though not conclusive, the fact that the statute gives the agency three explicit rule-making powers to apply to section 16(b), and none to apply to section 29(b), is a shaky literal beginning. Section 23(a) creates a far-reaching classification power, but the agencies can use it only on matters "within [the agencies'] respective jurisdictions" and as "necessary for the execution of the func-


\(^{121}\) 17 C.F.R. § 240.16b-3 (1964).

\(^{122}\) See 2 Loss, op. cit. supra note 97, at 1114-18; 3 id. at 1846-49.

\(^{123}\) Ibid.


\(^{125}\) Ibid.

\(^{126}\) Ibid.

\(^{127}\) Ibid.


tions vested in” them. Section 3 (b) is of little or no help, for it is hard to find a key technical, trade, or accounting term in section 29 (b). Furthermore, the courts — which must, rather than the agencies, adjudicate causes of action under the section — have been applying section 29 (b) since 1941. The experience of the Commission with its rules furnishing exemptions from section 16 (b) provides a further warning that private rights of action will be protected. If section 29 (a) voids stipulations binding private parties to waive their rights under the statute, section 29 (b) can be interpreted as voiding an attempt by an agency to waive the rights of private parties for them.

In short, section 29 (b) and the act contemplate that the agency can, in accordance with the standards of the act, adopt the rules it finds necessary and desirable and thus shape the requirements of the statute, but that section 29 (b) is to be applicable, under its terms, to all violations of the act and its rules, as so molded. Just as the Exchange Act does not allow the agency an option to determine the severity of criminal penalties or whether violations of some or all of its rules will or will not be crimes, the act is designed to give the agency no option concerning the interaction of its rules and section 29 (b). Agency rules purporting to override section 29 (b) should, therefore, be considered void for want of agency jurisdiction. This is not to say that given the clearest showing that, because of special circumstances, application of section 29 (b) will cause the act “to destroy itself,” the courts should not create an exception. But curtailment of this explicit investor protection — itself a congressional policy judgment — seemingly would require even more than would be required to curtail the tort doctrine.

VI. THE RULE-MAKING POWERS AND THE STATUTORY TORT DOCTRINE

An agency attempt to negate the statutory tort doctrine is an attempt to prevent the courts from applying a doctrine created and

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129 Such a delegation would raise constitutional problems. See JAFFE, op. cit. supra note 96, at 110. However, the existing scheme, under which there is an explicit definition of crimes, necessarily accomplishes a delegation concerning the institution of criminal proceedings, as a failure of the agency to make criminal references under Exchange Act § 21 (e), 48 Stat. 899 (1934), as amended, 15 U.S.C. 78u (e) (1964) effectively relieves the party from possible prosecution.

130 See note 143 infra.
shaped by them — albeit to violations of statutes. Specific expressed congressional intent concerning implied private rights pursuant to the doctrine is usually lacking; indeed, such intent is said to be relevant only if there is a plain negative intent. The broad purpose of the statute, including the persons and interests to be protected, is crucial, as shown by the United States Supreme Court's examination of section 14(a) and its legislative history in J.I. Case Co. v. Borak. There the Court found that the language of section 14(a) and the fact that one of its stated purposes was the protection of investors "clearly implies the availability of judicial relief where necessary to achieve that result." This comes close to a finding of clearly implied affirmative congressional intent. Implied rights have been considered, in Borak and other cases, as arising under the Exchange Act for the purposes of applying the jurisdiction, venue, and service-of-process provisions of section 27. Nevertheless, specific congressional intent concerning implied rights is less of a consideration under the tort doctrine — both in creation by the courts of implied rights and in determining the weight to be given to agency attempts to negate them — than under section 29(b). In applying the tort doctrine, the focus shifts from the rather specific affirmative congressional intent manifested in section 29(b) to an inquiry of the role of court and agency in effectuation of more broadly stated congressional purposes.

A negation rule purporting to overrule the tort doctrine is an attempt by the agency to promulgate an exclusive primary jurisdiction doctrine outsting the courts from a part of their traditional jurisdiction and depriving private parties of all implied rights of recovery under the Exchange Act, for there is no administrative mechanism for awarding private relief. As might be expected, nothing in the Exchange Act directly touches upon this. The shortcomings of section 23(a) in classifying persons out of implied rights have al-


133 377 U.S. 426 (1964).


135 See cases cited note 48 supra.

136 Primary jurisdiction is covered in 3 DAVIS, ADMINISTRATIVE LAW §§ 19.01-09 (1958); JAFFE, op. cit. supra note 96, at 121-51. The possibility of the agency's seeking relief for private persons in court, especially under negation rules phrased as are the Comptroller's, may remain. See text accompanying note 65 supra. See also notes 93 supra and 143, 147 infra.
ready been mentioned. 137 The considerable flexibility of the agencies in promulgating implementing rules does not cover the effect in private suits of violations of the rules and the Exchange Act. Section 3 (b) again furnishes no assistance to an agency, for the tort doctrine is not dependent upon a technical, trade, or accounting term in the Exchange Act. Nothing in the act, however, specifically forbids an agency to negate the tort doctrine, although section 27 138 is the hardest of hurdles for a negation rule.

The Borak case might be interpreted as a declaration that the standards and purposes permeating the Exchange Act — public interest and protection of investors — always require application of the tort doctrine 139 to provide relief whenever an investor or other person whose interests are protected by the act is injured by its violation. If so, questions whether the agency ever has jurisdiction to issue negation rules and of the intensity of judicial scrutiny of the rules (if the agency has some jurisdiction) become immaterial. The agency must operate within the purposes of the Exchange Act, 140 and if the purposes at this time automatically require application of the doctrine to protect investors and others, jurisdiction and intensity of review become unimportant; no amount of deference — short of total abdication — by the courts to the agency could save the rule. Certainly, a main purpose of almost the entire Exchange Act is protection of investors, 141 a purpose relied upon in Borak as "clearly" implying a private right. Yet, as discussed below, 142 given a showing that in a special situation, implied rights result in a net detriment to enforcement rather than a supplement or the "neces-

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137 See text accompanying note 127 supra.
139 Subject to the defenses that have been applied and subject to Borak's reference to "appropriate relief," which supplies needed flexibility, especially in proxy cases.
140 See materials cited supra note 125. In addition, see 78 CONG. REC. 8091 (1934) (remarks of Mr. Lea):

There is a broad power in the bill, but there are several standards, and in attempting to determine what those standards are the courts have a right to resort to all sections of the bill.... The standards of the Commission must be those which are consistent with the purposes of the bill.

S. REP. No. 792, 73d Cong., 2d Sess. 5 (1934), states that:

Accordingly, it is essential to entrust the administration of the Act to an agency vested with the power to eliminate undue hardship and to prevent and punish evasion. Of course, well defined limits must be indicated within which the authority of such administrative authority may be exercised.

141 See Baird v. Franklin, 141 F.2d 238, 244 n.4 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
142 See text accompanying notes 149-65 infra.
sary supplement" found in Borak, the cases on primary jurisdiction — especially the Supreme Court's early decision in Texas & Pac. Ry. Co. v. Abilene Cotton Oil Co. — would supply precedent for a court's restricting the Borak rationale. Proper purpose can thus conceivably be present, but should the possibility of proper agency purpose create agency jurisdiction to command the restriction of the jurisdiction of the courts?

The question then is how agency rule-making commands to the courts concerning implied rights should be handled. Should the

143 204 U.S. 426 (1907). A shipper, claiming a properly published rate was unreasonable, brought a common law action against the carrier in a state court. Though the Interstate Commerce Act stated that such remedies were not abrogated, the Court, reversing the state court, held the action would not lie and that only the ICC could determine reasonableness. The Court found that if — without previous action by the ICC, which had the authority to award reparations — courts could make decisions on reasonableness, there would be no uniform standard of rates, and this would render enforcement of the statute impossible. The most frequently quoted language in the opinion is that concerning the provision saving common law remedies. The Court held this could not contemplate a right absolutely inconsistent with the Act as "the Act cannot be held to destroy itself." Id. at 446. The case and the primary jurisdiction doctrine in its various forms are discussed in 3 DAVIS, op. cit supra note 136, at §§ 19.01-09; JAFFE, op. cit. supra note 96, at 121-51. See also notes 91, 93, and 136 supra.

In Silver v. New York Stock Exch., 373 U.S. 341, 357 (1963), the Court held that the act will be considered to have impliedly repealed the antitrust laws "only if necessary to make [the act] work, and even then only to the minimum extent necessary."

In Wills v. Trans World Airlines, Inc., 200 F. Supp. 360 (S.D. Cal. 1961), a prospective passenger refused air transportation showed a violation of the Federal Aviation Act and, under an implied rights theory, was awarded compensatory damages of $1.54 and exemplary damages of $5,000. Plaintiff's prayer for injunctive relief against the airline was held, however, to require referral to the CAB.

In Southwestern Sugar & Molasses Co. v. River Terminals Corp., 360 U.S. 411 (1959), the question of validity of a clause, in a tariff filed by a carrier with the ICC, purporting to limit common law liabilities for negligence was held to raise an administrative question for reference to the ICC for obtaining its views, as the transfer of risk may have affected the rate. In Dixilyn Drilling Corp. v. Crescent Towing & Salvage Co., 372 U.S. 697 (1963), the Court held, in a per curiam opinion, that an agreement by a barge owner in a towage contract to assume liability for all losses in towage, including any resulting from the tower's negligence, would not exempt the tower from liability, as between the two parties, for the tower's negligence. The Court, limiting Southwestern Sugar to its facts, relied upon earlier cases invalidating exculpatory clauses.

A high water mark for agency action — or more precisely, inaction — successfully limiting common law liability to private parties is Lichten v. Eastern Airlines, Inc., 189 F.2d 939 (2d Cir. 1951). The filing with the CAB by the airline of a tariff disclaiming all liability for certain losses was held to require the application of primary jurisdiction to a suit by a passenger for the value of jewelry in lost baggage. The majority found this required though the CAB has no reparations authority.

Linn v. United Plant Guard Workers, 383 U.S. 53 (1966) (5-4 decision), held that the NLRB does not have exclusive jurisdiction concerning alleged defamatory statements by a union and its officers during an organizing campaign and that an officer of the employer could maintain a civil action under state law for allegedly defamatory statements circulated by the union and its officers, provided they were circulated with malice and caused damage to the plaintiff. The majority felt that such suits would not interfere with the jurisdiction of the NLRB (which can award no damages to the defamed individual) over the merits of the labor controversy.
courts consider the agency totally without jurisdiction in the area, giving it only the traditional role of a party which may be able to furnish the courts with helpful and informed views and arguments to aid them in making their own implied rights determinations? Another possibility is to consider that the agency has inherent rule-making jurisdiction in proper cases to restrict the tort doctrine and section 27 but that the courts will, in a manner similar to that often followed in reviewing rules furnishing exemptions from section 16(b), independently and rigorously review the validity of any rule in light of its effectuation of congressional purposes. The effects of these two approaches would be about the same insofar as the statutory tort doctrine is concerned, as automatic ultra vires treatment of a rule negating the tort doctrine would leave available the judicial discretion inherent in the doctrine. A third possibility is (by rough analogy to the second Chenery case) for the courts to hold that the agency has inherent rule-making jurisdiction and to defer considerably to the agency's judgment.

An agency rule purporting to direct the courts to imply a private right would be considered automatically ultra vires, even if the agency's rule were based, for example, upon the best of findings that implied rights are a necessary supplement to its enforcement action. The courts are as well qualified as the agency to interpret section 29(b). The statutory tort doctrine has been created and developed by the courts, not the agencies. The courts hear the cases, decide questions of fact, and shape the remedies, as is recognized in section 27. The courts have eminent qualifications to discern the congressional purposes of the Exchange Act and the interests and classes of persons intended to be protected as well as to determine the fairness of allowing one private party to recover from another for injuries caused by violations of the Exchange Act.


147 Here, the qualifications of the courts outweigh the technical expertise of the agency. For a discussion of comparative qualifications, see 4 DAVIS, op. cit. supra note 136, § 30.09; JAFFE, op. cit. supra note 96, at 576-85. See also notes 93, 136, 143, and 146 supra.
An agency rule purporting to negate may be based on one or more of the same factors. The agency may conclude that strike suits by persons without meritorious causes of action will be an unbearable problem to those it regulates, a judgment implicitly rejected in *Borak*. The agency may simply not believe in *Borak* and be antagonistic to the concept of private recoveries. The agency may believe that it is the better judge of fairness or that the courts cannot be entrusted to fashion sensible relief. Or the agency may feel that it is a better interpreter of section 29(b) or of congressional purposes or intent or that it can better discern the interests and classes of persons that the act is intended to protect. Negation rules based on many of these grounds would, of course, be inconsistent with congressional purposes, but even more basically, negation rules based on *any* of these grounds should be considered outside the agency's area of jurisdiction. The congressional purposes are found in the Exchange Act and its legislative history, as is the lack of a negative intent on application of the tort doctrine. The agency's rules cannot change either and must carry out, not frustrate, congressional purposes. The Comptroller's rules appear to recognize this, as they do not state an agency purpose *not* to protect investors, which would be impermissible under the standards of the Exchange Act. Nor do they purport to announce the discovery of a negative congressional intent on implied rights. The rules only state an agency intent of no private enforcement, and it has been congressional purpose rather than agency intent on implied rights that has been decisive in applying the tort doctrine.

The agency's views on congressional purposes, interpretation of section 29(b), fairness, the dangers of strike suits, and similar matters may be valuable to the courts; but the comparative qualifications of court and agency on these considerations should not lead to a judicial creation of inherent agency rule-making power to oust the courts from their traditional jurisdiction exercised under section 27.

However, a negation rule may be based upon an ostensible finding, belief, or apprehension that the implication of private rights would be a net detriment to enforcement. As noted, a clear showing in a special situation of net detriment to enforcement should be grounds for a court to limit implied rights. Does this change the picture? But first, how would a net detriment arise? *Borak* found private actions a "necessary supplement" to the Commission's proxy

148 See note 147 *supra*. 
rules. The Senate Report on the Exchange Act pointed out, in discussing express private rights, the inadequacies of relying solely on criminal penalties and noted further that "if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party." On the other hand, the agency may feel that a substantive rule must necessarily be broad and general and that while its discretion in administering the rule can be trusted to avoid unfairly penalizing those who in good faith attempt to comply, but fail, the possibility of civil recoveries by private plaintiffs against such violators would preclude the agency's adoption of the rule in that form. Or, the agency may believe that private plaintiffs' actions will result in adverse court decisions on the scope of the statute or the agency's rules. Neither ground is persuasive. The agency has a uniquely good set of tools for dealing with the problems that may be created by a broad, general rule. The rule can be — and often should be in any event — made more definite by examples in the rule or by explanatory releases. Procedures in the rule for ad

149 S. REP. NO. 792, 73d Cong., 2d Sess. (1934).
150 Id. at 12.
151 In Nashville Milk Co. v. Carnation Co., 355 U.S. 373 (1958), the question was one of construing the Robinson-Patman Act and the Clayton Act to determine whether private causes of action could be brought under the latter for sales at unreasonably low prices for the purposes of destroying competition or eliminating a competitor which are forbidden only by § 3 of the former. Mr. Justice Harlan, writing for the majority, construed the two statutes and concluded no private action would lie. He said:
It is not an idle conjecture that the possibility of abuse inherent in a private cause of action based upon this vague provision was among the factors which led Congress to leave the enforcement of the provisions of § 3 solely in the hands of the public authorities, except to the extent that violation of any of its provisions also constituted a violation of § 2 of the Clayton Act. . . . Id. at 378-79 (Footnotes omitted).


As pointed out in the text accompanying notes 151-57 infra, an agency administering the Exchange Act has clarifying and other limiting tools superior to those available in the administration of the antitrust statutes, and, in addition, single rather than treble damages are at stake in implied rights actions under the Exchange Act.

152 The Internal Revenue Service employs examples effectively. The sixteen examples in Treas. Reg. § 1.355-1(d) (1955) may represent the most extensive use by the Service. Examples and specific prohibitions can be used in addition to general proscriptions and can be designed so as not to limit the salutary reach of a general proscription in the inevitable situations where the ingenious devise ways to avoid the letter of
hoc exemptions and provisions that good faith attempts to comply will be deemed compliance (a technique adopted by the FRB in its margin rules) can also be used where necessary. As to the second ground, some of the landmark cases liberally construing the Exchange Act and the Commission's rules have been brought by private plaintiffs. Moreover, the filing of amicus curiae briefs and applications for intervention are available to the agency. In any event, the additional enforcement muscle provided by private plaintiffs is much more important to an agency that wants the Exchange Act and its rules effectively enforced than the possibility that some of the legal arguments of some of the private plaintiffs may not be as good as those the agency presents in its own court actions.

Suppose the agency says a negation clause was inserted in a given substantive rule that is quite definite in the requirements it imposes simply because of intense industry opposition to the rule, absent negation? Congress apparently made a similar compromise in 1938 when it added sections 15(c)(2) and 15(c)(3), which authorize Commission rules reasonably designed to “prevent” fraudulent conduct by broker-dealers in over-the-counter transactions and imposing financial responsibility requirements upon broker-dealers doing any over-the-counter business. After industry opposition during the congressional hearings to the sections — especially section 15(c)(2) — and implication of private rights upon violations of rules under them, Congress did not delete the sections, although they were modified. Congress did, however, remove vio-

specific prohibitions. See, e.g., Rule 15c1-2(c), 17 C.F.R. § 240.15c1-2(c) (1964) (states expressly that Rule 15c1-2, the general antifraud rule under § 15(c) (1), is not limited by other, specific rules under the section).

154 See, e.g., Rule 15c3-1 (b) (3); Rule 14a-11 (c).
155 12 C.F.R. §§ 220.6(k), 221.3(h) (1963).
lations of rules under the two sections from section 29 (b). What weight should be given to this pragmatic argument, one which, incidentally, an agency may hesitate to articulate? If an agency is denied negation power and actually fails to adopt a rule because of the implied rights that would flow from it, investors are the losers. The argument could not justify the wholesale negation attempted by the Comptroller, but it could have some practical appeal on specific rules in frontier areas of regulation. On balance, however, this argument must, if the agency should choose to advance it, be given no force. Where Congress has created and delegated power to an agency, the necessary expectation and standard must be that the agency will have the independence effectively to exercise the authority according to the delegation standards and congressional purposes. The private rights of investors harmed by violations should not be sacrificed to take the pressure off an agency in promulgating what by definition is a desirable rule.

Though the three foregoing possibilities seem to offer no support for a conclusion that implied rights could be a net detriment to enforcement, they are obviously not exhaustive. Regulation under the Exchange Act will probably continue to be fast-moving, as it has been since the 1930's. Though implied rights have, to date, been a decided advantage in the enforcement and attainment of the congressional purpose, in special circumstances the opposite may be true. For example, the Comptroller administers the National Bank Act as well as a portion of the Exchange Act. Although neither the FRB nor the FDIC adopted a negation rule, the Comptroller may be able to show that because of something unique in banking regulation, implied rights under the Exchange Act would constitute a net detriment to his enforcement of the National Bank Act or the act. Also, section 19 (b) (9) — which authorizes the Commis-

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160 See the provisos in § 29 (b); materials cited in 3 Loss, op. cit. supra note 157, at 1760 n.253.

161 For example, Rule 10b-5 was not adopted until 1942. See 3 Loss, op. cit. supra note 157, at 1426-27. The vast changes in the proxy rules from 1935-1960 are summarized in 2 Loss, op. cit. supra note 157, at 869-71.


ison to effect changes in exchange rules concerning "the fixing of reasonable rates of commission . . . and other charges" — could produce problems.\textsuperscript{164} If the section were construed to give individual investors an implied private right to challenge exchange commission rates as unreasonable or discriminatory — an unlikely but not impossible private cause of action to imply under the Exchange Act — the Commission should be held to have primary jurisdiction, requiring at a minimum giving the Commission an opportunity to conduct an appropriate proceeding and to furnish its views to the court.\textsuperscript{165}

\textsuperscript{164} Ibid.

\textsuperscript{165} Primary jurisdiction and antitrust are discussed in the materials cited in note 2 supra. If Kaplan v. Lehman Bros., TRADE REG. REP. (1966 Trade Cas.) § 71697 (N.D. Ill. Feb. 25, 1966) is followed, the antitrust laws will bow considerably to the Commission's § 19(b) (9) authority.

Implication of a private right under the Act by reference to § 19(b) (9) is unlikely, for § 19(b) authorizes the Commission to request the alteration or supplementation of exchange rules and to alter or supplement, after notice and opportunity for hearing, if the exchange does not act. The Kaplan case indicates that commission rates are almost completely in the Commission's jurisdiction. However, Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), extensively discussed in part II, created an implied private right out of a statutory direction to the Commission; the direction, however, left the Commission with no discretion, and Judge Clark viewed § 19(a) (1) (Commission authority to discipline exchanges) as not creating an implied private right. \textit{Id.} at 245. Section 36 of the Investment Company Act, 54 Stat. 789 (1940), as amended, 15 U.S.C. §§ 80a-1 to -52 (1964), which authorizes Commission requests for injunctive relief against persons alleged to have committed gross abuses of trust or gross misconduct, has been held by one court to create an implied private right; the question of implied rights under that section is unsettled, however. For a discussion of § 36, see Eisenberg & Phillips, \textit{Mutual Fund Litigation — New Frontiers for the Investment Company Act}, 62 COLUM. L. REV. 73 (1962); Eisenberg & Lehr, \textit{An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under The Investment Company Act of 1940}, 20 RUTGERS L. REV. 181 (1966).

In Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960), aff'd, 313 F.2d 472 (3d Cir.), cert. denied, 374 U.S. 806 (1963), the stockholders of a mutual fund relied upon, \textit{inter alia}, § 35(d) of the Investment Company Act and the common law doctrine of unfair competition in requesting relief including the enjoining of another mutual fund from the use of a portion of the name of their mutual fund in the other mutual fund's name. Section 35(d) forbids a mutual fund or any other registered investment company to adopt as a part of its name or title "any word or words which the Commission finds and by order declares to be deceptive or misleading." (Emphasis added.) The court of appeals considered at some length the question whether the section creates an implied private right, the majority concluding that it is "legally debatable" but certainly "not frivolous." Thus, the district court's finding of pendent jurisdiction over the common law claim was upheld. See also notes 93, 136, 143, 146, and 147 supra and accompanying text. \textit{Cf.} Strubekaker Corp. v. Gittlin, CCH FED. SEC. L. REP. § 91657 (2d Cir. April 5, 1966) (private action under proxy rules to enjoin state court proceedings; despite the anti-injunction statute, the court affirmed the granting of the injunction, equating the Commission's right and the right of the private party).

Finding an implied private right under the Act, but making use of an appropriate primary jurisdiction doctrine, would allow the Commission to retain effective jurisdiction but force it publicly to go on record and perhaps to hold proceedings periodically. The approach could be a flexible and salutary tool available to the courts if it is decided that while there is antitrust immunity, individual investors and classes of investors
As discussed earlier,\textsuperscript{166} negation rules based upon anything other than net detriment to enforcement should be considered outside the agency's jurisdiction, and precedent and protocol would indicate that rules purportedly based upon that ground should be treated the same way. The general scheme of the Exchange Act is that the courts pass upon the jurisdiction and actions of the agencies and not that the agency contracts the jurisdiction of the courts. Implied rights have traditionally been considered in the province of the courts and have been shaped by them, not the agencies. Where, however, net detriment may be a ground — which may be the case on the extant rules, although none is supported by a public announcement of reasons — agency expertise presents a new dimension. The courts, in passing upon the relationship of the antitrust and the regulatory laws, must decide questions similar to those involved in reviewing the interaction of the statute and the judicially-created tort doctrine,\textsuperscript{167} but the agency's knowledge of the problems of administering its own statute is a significant consideration. Is it significant enough to warrant the creation of inherent agency rule-making power to negate, and thus restrict the grant of jurisdiction to the courts in section 27,\textsuperscript{168} a grant to which \textit{Borak} paid considerable attention? Is the traditional approach — treating implied rights as being wholly within the courts' jurisdiction — too inflexible?

Under the traditional approach to implied rights, an agency negation rule would be considered automatically ultra vires, and judicial discretion in applying the tort doctrine would be counted upon to give proper effect to any valid net-detriment-to-enforcement consideration underlying the rule. Erasure of section 29(b) rights can seemingly be accomplished only in this manner; so far, section 29 (b) and the tort doctrine have usually travelled together, and separate treatment at this juncture would seem anomalous. Moreover,

\textsuperscript{166}See text accompanying notes 147-48 \textit{supra}.

\textsuperscript{167}In \textit{Silver v. New York Stock Exch.}, 373 U.S. 341 (1963), the Court measured the effects of the application of the antitrust laws to the NYSE's actions in that case upon the scheme of self-regulation and Commission regulation under the Act before finding the lack of antitrust immunity. The Court found that the aims of the Exchange Act were defeated, rather than furthered, by the NYSE's conduct complained of in the case. \textit{Id.} at 361-67.

it has been seen that there are many totally invalid reasons why an agency may wish to negate the tort doctrine.

The traditional implied rights approach to negation rules would not interfere with the work of the agencies. For one thing, an agency's substantive rules are not at issue; the legal duties to the government are the same whether or not implied private rights flow from violations. If the agency's reasons for desiring an exception to the implied rights doctrine are valid and consistent with the congressional purposes, they will undoubtedly be honored by the courts. And as discussed below, certainty to potential defendants is no consideration; if the courts were to create agency jurisdiction but independently scrutinize negation rules for consistency with congressional purpose, rules declared invalid would furnish no shield under section 23(a) for violations of the Exchange Act occurring before invalidation. Agencies can, furthermore, use rule-making and other releases to announce, in advance and in advisory form, the position they will urge in court on implied rights issues. Indeed, use of this procedure might encourage a "full disclosure" by the agency of the reasons why it believes a specific situation should require a reversal of the Borak rationale.

There appears to be no good reason why the courts should manufacture for the agencies an inherent rule-making power for the latter to use in turn to override section 27 and command the courts to relinquish their traditional independent jurisdiction in handling the tort doctrine. Indeed, protection of investors — a main purpose of the Exchange Act — will best be accomplished by the traditional approach. That approach will assure investors that their rights under the statutory tort doctrine — a fruitful and dynamic marriage of congressional purpose and judicial alertness to its effectuation — will be negated only where an independent inquiry reveals actual special considerations that cause private actions to be a net detriment rather than a supplement or a "necessary supplement" to agency action.

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169 See text accompanying notes 172-79 infra.


171 It is for the federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded. "And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done." Bell v. Hood, 327 U.S. 678, 684 (1946).

VII. THE FINAL CONSIDERATION: EFFECT OF GOOD FAITH RELIANCE PROVISIONS OF SECTION 23(a)

A final — and crucial — issue turns on the declaration in section 23(a) that "no provision [of the Exchange Act] imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation [of the applicable agency]...". This results even though the rule or regulation may, after the act or omission, "be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." Do all negation rules necessarily give immunity for violations occurring before the first judicial holding of invalidity?

Section 23(a) has been given broad scope in cases involving invalid or questioned Commission rule-making exemptions from section 16(b). In those cases, the courts have held or assumed that private parties need not inquire into the legal basis for a rule as long as it remains unrevoked and there is no judicial holding of invalidity.

The section 16(b) cases are distinguishable in two respects, however. Section 16(b) does not make anything unlawful or impose legal duties on an insider. It only creates a civil cause of action in an insider makes a profit from specified short-swing trading. In the section 16(b) cases, the parties relying upon the exemptive rules were, therefore, not legally bound to buy or sell stock — the acts creating civil liability — and they usually or often would have timed their transactions differently but for good faith reliance upon the exemptive rules. As a leading case put it in determining that a defendant would be entitled to protection under section 23(a): "defendant's continued participation... and his ultimate exercise of the option... followed by his immediate sale of the stock, would not have occurred were it not for his good faith reliance on the SEC

\footnote{173}{Ibid.}
\footnote{174}{See 3 Loss, op. cit. supra note 157, at 1842-49. Where a rule is declared invalid before the defendant commits the act for which liability is imposed, § 23(a) furnishes no immunity. B. T. Babbit, Inc. v. Lachner, 332 F.2d 255, 259 (2d Cir. 1964). For a discussion of the problems of persons in districts and circuits other than the one in which the rule is held invalid, see 3 Loss, op. cit. supra note 157, at 1849.}
\footnote{175}{Ibid.}
regulation defining an officer." A negation rule, on the other hand, purports to relieve one who violates a statutory duty from liabilities to those he injures; it does not relieve the violator from his duties to comply with the Exchange Act or place him outside the reach of governmental enforcement machinery. Thus, the only possible reliance upon a negation rule can be a feeling that compliance is not important if only the agency can act. This is hardly the kind of reliance present in the section 16(b) cases. In the language of section 23(a), a violation of the Exchange Act cannot be "done or omitted in good faith in conformity with" a negation rule. There is no unfairness in automatic invalidation of a negation rule and finding that immunity under section 23(a) is unavailable. Moreover, the voiding of a negation rule clearly should not cause the implementing rule to fall. None of the negation rules contains a statement of agency intent trying to tie the two together, and even if such an intent were stated, it should be disregarded. The job of the agencies is to implement the Exchange Act and not to attempt to construct implementing rules that collapse when bootstrapping experiments with negation rules fail.

The section 16(b) cases were also devoid of allegations of false or misleading statements, fraud, or actual misuse of inside information by the defendants. If a violation purported to be removed from section 29(b) and the tort doctrine involves fraud or a false or misleading statement or report, "good faith" may be lacking, especially if an element of scienter is present. If this analysis is correct, potential defendants, obligated in any event to comply with the Exchange Act and subject to governmental enforcement remedies for violations, must regard a negation rule as going no further than furnishing some assurance that in any action


179 In one of the § 16(b) cases, Van Aalten v. Hurley, 176 F. Supp. 851 (S.D.N.Y. 1959), the court favorably noted the defendants' compliance with the reporting requirements of § 16(a). The recent decisions of the Supreme Court refusing to give some of its overruling constitutional criminal law opinions retrospective effect in habeas corpus applications (Tehan v. United States, 382 U.S. 406 (1966); Linkletter v. Walker, 381 U.S. 618 (1965)) seem inapposite in applying § 23(a). Section 23(a) specifies when an invalid rule can furnish protection, and a defendant unable to meet § 23(a)'s requirements appears to have no constitutional grounds for complaint. Furthermore, for the reasons stated in the text, reliance on a negation rule is weak, at best, whereas reliance by law enforcement officials and prosecutors upon prior decisions of the Court was strong in the situations ruled upon in Tehan and Linkletter, supra, especially in the former.
brought against them by private plaintiffs, the agency will appear on their side to urge that a special circumstance which prompted the agency to promulgate the rule should be regarded by the court as justifying a judicially created exception to the implied rights doctrine.

PART II

IMPLIED RIGHTS UNDER THE EXCHANGE ACT FOR VIOLATIONS OF SELF-REGULATORY REQUIREMENTS

The second portion of this article discusses the efforts of private plaintiffs to find implied rights under the Exchange Act for violations by broker-dealers and companies of the rules and requirements of the exchanges and the National Association of Securities Dealers, Inc. (NASD), private organizations which under the act require significant investor protections and which play an integral part in securities regulation in America. This part also briefly discusses the rule-making authority of the Commission and of the self-regulators to negate any such private rights that might be implied by the courts.

Again, a recent development best poses the question. In Colonial Realty Corp. v. Bache & Co., decided March 10, 1966 by the Second Circuit, the issue was whether an alleged breach of the most far-reaching of the self-regulators' requirements, that member firms observe just and equitable principles of trade, could form the basis of an implied right under the Exchange Act. The Second Circuit, after the most thorough judicial consideration to date of implied rights for violations of the requirements of the self-regulators, held a good federal claim was not stated. The court, however, carefully left open the possibility of implied rights under the Exchange Act for violations of other self-regulatory requirements — for example, those that "play an integral part in SEC regulation." In its dictum — that there is a possibility of implied rights without a showing of a violation of the act or Commission rules — the opinion is a sophisticated groundbreaker.

Much of this portion is devoted to an analysis of the Colonial

Realty opinion. Preceding that, however, the rather complex statutory scheme of Commission regulation and self-regulation is discussed, some considerations of policy and construction are outlined, the effect given to violations of self-regulatory requirements under state law is analyzed, and the pre-Colonial Realty cases under the Exchange Act are discussed. Following the analysis of the Colonial Realty opinion is the brief discussion of the authority of the Commission or the self-regulators to negate, by rule, any implied rights for violations of self-regulatory requirements that the courts might imply. A suggested test is included in the conclusion.

I. THE STATUTORY SCHEME

A. Registration and Requirements of the Self-Regulators

As required and sanctioned by the Exchange Act, the rules of the nation's registered securities exchanges and the NASD impose a host of requirements on their member broker-dealer firms.\textsuperscript{181} In 1934, Congress proceeded on the theory that exchanges should be treated as "public institutions" and not "private clubs." The House Committee felt that "the great exchanges of this country upon which millions of dollars of securities are sold are affected with a public interest in the same degree as any other great utility."\textsuperscript{182} The unique system of governmental control — initiative in the exchanges, governmental oversight, and governmental power in reserve — is summarized in this statement from the House Report:

The Commission is empowered, if the rules of the exchange in any important matter are not appropriate for the protection of investors or appropriate to insure fair dealing, to order such changes in the rules after due notice and hearings as it may deem necessary. The exchanges may alter their rules if more effective means are discovered to meet the same or new problems. Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped that the effect of the bill will be to give to the well-managed exchanges that power necessary to


\textsuperscript{182} H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934), reprinted 78 CONG. REC. 7701, 7706 (1934).
enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise.\textsuperscript{183}

(1) \textit{Registration of Exchanges Under Sections 5 and 6.}—Section 5 of the Exchange Act\textsuperscript{184} requires exchanges to register with the Commission. Under section 6(a)(1),\textsuperscript{185} the exchange must, as a prerequisite to registration, file an agreement to comply, and enforce, so far as is within its powers, compliance by its members with the act and Commission rules.

Section 6(b)\textsuperscript{186} states that "no registration [of an exchange] shall be granted or \textit{remain in force} unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade..."\textsuperscript{187} Under the section, the exchange rules must declare the willful violation of the Exchange Act or agency rules to be such inconsistent conduct. The non-waiver language in section 29(a)\textsuperscript{188} includes this rule within its voiding of any provision "binding any person to waive compliance with any provision [of the Exchange Act or agency rules thereunder], or of any rule of an exchange required thereby..."\textsuperscript{189}

Section 6(c)\textsuperscript{190} declares that nothing in the Exchange Act precludes an exchange from adopting and enforcing any rule not inconsistent with the act or agency rules or the law of the state in which the exchange is located. Section 6(d)\textsuperscript{191} instructs the Commission to approve an exchange's registration application if it appears that the exchange can comply with the Exchange Act and agency rules "and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors..."\textsuperscript{192}

(2) \textit{Registration of National Securities Associations Under Section 15A.}—Similar requirements govern the registration of national

\textsuperscript{183} Ibid.
\textsuperscript{189} Ibid. The language is discussed in 3 Loss, \textit{op. cit. supra} note 157, at 1812.
\textsuperscript{192} Ibid.
securities associations — organizations of over-the-counter broker-dealers designed to provide self-regulation in the over-the-counter markets comparable to that the exchanges furnish concerning their members. The formation of these organizations is authorized by section 15A, added in 1938 by the Maloney Act. The NASD, the only securities association registered or ever to apply for registration under the act, counts among its members 3,865 of the 4,543 broker-dealers registered with the Commission. Since registration with the Commission is required for virtually all broker-dealers (including exchange members) doing any over-the-counter business, all NASD members are subject to regulation by the Commission and the NASD. Many NASD members are also members of one or more exchanges.

When the Maloney Act was passed, the congressional committees discussed at some length their philosophy of self-regulation. The following excerpt from the reports shows the contrast between the Commission's regulation by law and the self-regulatory controls, the dependence upon the government to supervise and exercise supplementary direct powers, and the similarities between exchange and NASD functions:

The committee believes that there are two alternative programs by which this problem could be met. The first would involve a pronounced expansion of the organization of the Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law. It might very well mean expanding the present process of registration of brokers and dealers with the Commission to include the proscription not only of the dishonest, but also of those unwilling or unable to conform to rigid standards of financial responsibility, professional conduct, and technical proficiency. The second of these alternative programs, which the committee believes distinctly preferable to the first, is embodied in S. 3255. This program is based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation. In the concept of a really well-organized and well-conducted stock exchange, under the supervision

193 See 2 Loss, op. cit. supra note 157, at 1359-91; Phillips & Shipman, supra note 181, at 797-845; §§ 15A(b)(8)-(9), 15A(e).


195 See 2 Loss, op. cit. supra note 157, at 1288-1301; Phillips & Shipman, supra note 181, at 801-02.
provided by the Securities Exchange Act of 1934, one may perceive something of the possibilities of such a program.\(^{196}\)

In its report on the 1964 amendments,\(^{197}\) the Senate Committee again spoke on self-regulation, once more distinguishing between the illegal and the unethical:

A significant part of the regulation of the securities markets provided in the Securities Exchange Act is based upon the concept of self-regulation by industry organizations, under the supervision of the Commission. This philosophy was notably reaffirmed in 1938, when Congress enacted section 15A of the act. This extensive reliance on self-regulation rests on two principal premises; first, it provides an alternative to a much more pervasive direct regulation by the Government, which would be expensive to the taxpayers and burdensome to the industry, and it also provides a more sensitive and effective device for regulation in the area of unethical as distinct from illegal conduct.\(^{198}\)

Similar characterizations of self-regulation appear in the Special Study and elsewhere.\(^ {199}\)

(3) Rules and Requirements Promulgated by the Self-Regulators.—Because section 6(b) specifies that a willful violation of the Exchange Act or Commission rules is, in addition, a violation of just and equitable principles,\(^ {200}\) the self-regulators must aid in the enforcement of the law, but they are also expected to move beyond the Commission's legal requirements.

In addition to the general rule requiring adherence to just and equitable principles of trade (the section 6(b) rule), the self-regulators have many other rules, some of which overlap with the section 6(b) rule, adopted primarily for the protection of investors. A well-known example is the rules of many exchanges forbidding, with some exceptions, member firms from voting street-name stock

\(^{196}\) S. REP. NO. 1455, 75th Cong., 3d Sess. 3-4 (1938); H.R. REP. NO. 2307, 75th Cong. 3d Sess. 4-5 (1938).


\(^ {198}\) Ibid. This was said in connection with required membership in a registered securities association, deleted in the House. See notes 268-78 infra and accompanying text.

\(^ {199}\) Special Study, pt. 4, at 693-728. In Avery v. Moffatt, 187 Misc. 576, 592, 55 N.Y.S.2d 215, 228 (Sup. Ct. 1954), an action under state law for damages for allegedly wrongful action of an exchange in suspending members, the court said:

[T]here is a large area for the operation of exchange rules on the level of business ethics rather than law, and in that sphere the statute leaves it to the exchanges to carry on the necessary work of prevention and discipline.

\(^ {200}\) See, however, note 252 infra.
except in accordance with the instructions of beneficial owners.\textsuperscript{201} Exchanges also sign listing agreements with companies listing their securities for trading. The agreements contractually bind the issuer to do certain things (such as make prompt disclosure of material events) for the benefit of investors, and exchange policies or guides are often implemented so as to give investors additional protections.\textsuperscript{202}

(4) Commission Power Over Rules and Requirements of Self-Regulators.—Under the Exchange Act the Commission's powers over the rules and requirements of the self-regulators— in addition to the Commission's authority to issue its own rules—\textsuperscript{203} are extensive. Under a standard essentially of public interest and protection of investors, the Commission can, aside from its power over initial registration, disapprove proposed alterations in, or additions to, NASD rules and abrogate existing rules of that organization.\textsuperscript{204} In four areas concerning the organization and operation of the association as such, but not business or selling practices of members, the Commission can alter or supplement NASD rules.\textsuperscript{205} The pattern of authority over exchange rules differs somewhat. The Commission may not veto action of an exchange in adding to or changing


\textsuperscript{202} For the listing agreements currently in use by the two largest exchanges, see CCH AMER. STOCK EXCH. GUIDE 8955 (Listing Form L); N.Y. STOCK. EXC. CO. MANUAL A-17 to A-28. An example of implementation of a policy is the NYSE's requirement that, with some exceptions, proxies be solicited for all meetings of owners, even if the company came on the exchange at a time when the listing agreement contained no such requirement. The sanction for noncompliance by such a company is delisting. See also Securities Exchange Act § 14(c), 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78n(c) (1964); Kroese v. New York Stock Exch., 227 F. Supp. 519 (S.D.N.Y. 1964); 2 Loss, \textit{op. cit. supra} note 157, at 1027-28; Phillips & Shipman, \textit{supra} note 181, at 789-95 (changes in statute made by 1964 amendments).


\textsuperscript{205} Exchange Act § 15A(k)(2), 52 Stat. 1070 (1938), 15 U.S.C. § 78o-3(k)(2) (1964). The procedure (which includes notice and opportunity for hearing) and standard, as well as the effect of the 1964 amendments, are briefly discussed in Phillips & Shipman, \textit{supra} note 181, at 844.
its own rules; but on a wide variety of subjects, including many business and selling practices, the Commission may, under section 19(b), alter or supplement exchange rules.

The Commission reviews NASD disciplinary action against its members and their associated persons for violations of NASD rules. In a review proceeding, which may be de novo, the Commission can set aside or decrease, but not increase, any penalty. Commission review authority also exists for NASD denials of membership or registered representative status. There is no similar Commission authority to review specific disciplinary and denial actions of an exchange.

If an exchange violates the Exchange Act or Commission rules or fails to enforce, so far as is within its power, compliance therewith by a member firm or a company with a security listed thereon, its registration may be suspended or revoked under section 19.

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208 Exchange Act § 6(a) (4), 48 Stat. 885 (1934), 15 U.S.C. § 78f(a) (4) (1964), requires, as a condition of registration, an agreement that copies of amendments will be filed with the Commission forthwith upon adoption. Recently adopted SEC Rule 17a-8, 17 C.F.R. § 240.17a-8 (Supp. 1965) requires advance "reporting" three weeks before action by members or the governing body. Silver v. New York Stock Exch., 373 U.S. 341, 357 (1963) (see text accompanying notes 215-21 infra) may imply that §§ 19(b) and 6(a) (4) in combination allow the Commission to disapprove in advance, although a literal reading of the sections indicates the Commission's only statutory recourse is to alter or supplement under section 19(b).


208 See 2 Loss, SECURITIES REGULATION 1179-83 (2d ed. 1961). The Commission must first request the exchange to alter or supplement. If the exchange does not act, the Commission moves by notice and opportunity for hearing. If it finds the change "necessary or appropriate for the protection of investors . . .", the Commission then either issues its own order or its own rule changing the rules of the exchange. The procedure for allowing the Commission to alter or supplement by its own rule, if it chooses, was purposely inserted to restrict judicial review if such a choice is made. See 78 CONG. REC. 8087-93 (1934). See also H.R. REP. No. 1838, 73d Cong., 2d Sess. 37 (1934). But see 2 Loss, op. cit. supra, at 1183 n.40.

209 See 2 Loss, op. cit. supra note 208, at 1371-80; Phillips & Shipman, supra note 181, at 834-36, 841-43 (changes made by 1964 amendments).

210 2 Loss, op. cit. supra note 208, at 1371-80.

211 2 Loss, op. cit. supra note 208, at 1371-87; Phillips & Shipman, supra note 181, at 829-32, 834-36, 841-43 (changes made by 1964 amendments).

212 See Special Study, pt. 4, at 719-28; 2 Loss, op. cit. supra note 208, at 1178. The Court's opinion in Silver v. New York Stock Exch., 373 U.S. 341, 364 n.16 (1963), may have interpreted § 19(b) broadly enough to allow the Commission to alter or supplement exchange rules on disciplinary procedures. The reference there, however, concerned nonmembers, and § 28(b) might present an obstacle to the use of § 19(b) powers concerning member disciplinary procedures.
The NASD is subject to an even more comprehensive suspension and revocation power.\textsuperscript{214}

B. Statutory Duty of Self-Regulators To Enforce Their Requirements

The statutory duty of self-policing by exchanges has been considered by the federal courts in antitrust and implied private rights contexts. In 1963, the Supreme Court considered the extent to which the self-regulatory scheme gives the NYSE antitrust immunity. The case,\textit{Silver v. New York Stock Exchange},\textsuperscript{215} was a treble-damage action against the NYSE for damages resulting when it ordered its members, pursuant to its rules, to terminate direct wire connections with the plaintiff firms, which were not NYSE members. Advance notice and a requested opportunity for hearing were not given the plaintiffs. The Court noted that the NYSE's action was a per se violation of section 1 of the Sherman Act unless the Exchange Act supplied immunity.\textsuperscript{216}

After referring to the absence of an express repealer in the Exchange Act, the Court held the act impliedly repeals the antitrust laws "only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."\textsuperscript{217} Pointing out that specific actions of the type before it were not subject to Commission review and that the purposes of the Exchange Act were frustrated, not furthered, by the NYSE's actions complained of in the case, the majority of the Court found the actions without antitrust immunity.\textsuperscript{218}

In reviewing the rules of the NYSE under which it acted and the scope of self-regulation generally, the Court recognized the im-

\textsuperscript{213} Exchange Act § 19(a) (1), 48 Stat. 898 (1934), as amended, 15 U.S.C. § 78s (a) (1) (1964). The Commission must find, after notice and opportunity for hearing, the violation and that disciplinary action is necessary or appropriate for the protection of investors. Judge Clark's dissenting opinion in Baird v. Franklin, 141 F.2d 238, 240 (2d Cir.), cert. denied, 323 U.S. 737 (1944), indicates that § 19(a) (1) itself affords no implied private right of action against an exchange, although he did find an implied right for investors damaged by an exchange's failure to discharge the duty imposed by § 6(b). See also 2 Loss, \textit{op. cit. supra}, note 208, at 1175-78.

\textsuperscript{214} § 15A(1) (1) (including as grounds failure to enforce compliance with own rules or engaging in any other activity tending to defeat the purposes of § 15A). See also Phillips & Shipman, \textit{supra} note 181, at 839-40 (discussion of a new suspension power added by 1964 amendments). Virtually the same standards and procedural safeguards contained in § 19(a) (1) (see immediately preceding note) are present.

\textsuperscript{215} 373 U.S. 341 (1963).

\textsuperscript{216} Id. at 347-49.

\textsuperscript{217} Id. at 357.

\textsuperscript{218} Id. at 357-63.
portant role played by self-regulators. Referred to was "the federally mandated duty of self-policing by exchanges."\textsuperscript{219} The Court, rejecting the district court's narrow approach to NYSE regulation of trading in over-the-counter securities by member firms, found that the rules applied were germane to the "duty, implied by section 6(b) and section 6(d), to have rules governing members' transactions and relationships with nonmembers."\textsuperscript{220} The opinion thus did not downgrade the role of self-regulators, although nothing in it equates NYSE rules with statutory provisions.\textsuperscript{221} Indeed, the absence of a statutory requirement to handle notice and opportunity for hearing as the NYSE did and the absence of governmental review by the Commission of specific NYSE actions under the latter's rules were key considerations.

The crucial importance of the self-regulators in effective investor protection under the Exchange Act was recognized in 1944 by the Second Circuit in Baird v. Franklin,\textsuperscript{222} a landmark implied rights case and the one most directly relevant to the question of implied rights for violations of self-regulatory requirements. There, two customers of an insolvent NYSE member sued the NYSE for losses allegedly sustained by them by reason of conversion of their securities by the senior partner of the member. The losses were alleged to have resulted from the NYSE's failure to take action against the firm upon learning of mishandling of assets of the NYSE Gratuity Fund by the senior partner. The majority upheld the district court's judgment against the plaintiffs,\textsuperscript{223} holding requisite causation to be absent, although they acceded "to the view that the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937, after there was reason to believe that the latter had converted the plaintiffs' securities."\textsuperscript{224} Judge Clark dissented\textsuperscript{225} on the causation holding and explained why there was an implied right under the Exchange Act. He found

\textsuperscript{219} Id. at 352.
\textsuperscript{220} Id. at 353-57.
\textsuperscript{221} The dissenting opinion did, however, refer to a delegation of governmental powers. \textit{Id.} at 371. This raises the old chestnut whether the self-regulators derive their powers under state law (the same as other corporations or voluntary associations), receiving something of an antitrust umbrella from the Act and being subject to its restrictions, or whether they derive power from the Act. See Westwood & Howard, supra note 181, at 529-30.
\textsuperscript{222} 141 F.2d 238 (2d Cir.), \textit{cert denied}, 323 U.S. 737 (1944).
\textsuperscript{223} Id. at 239.
\textsuperscript{224} \textit{Ibid.}
\textsuperscript{225} Id. at 240.
the mishandling a violation of the Exchange Act, and hence of just and equitable principles and noted other violations of just and equitable principles by the senior partner. He construed section 6(b) as placing a duty on the NYSE to enforce the section 6(b) rule, stating that "any other construction would render the provision meaningless."226 Holding that the purpose of sections 6(b) and 6(d), when read together, was to insure fair dealing and to protect investors, he stated that an implied right was available under the act pursuant to the statutory tort doctrine.227 On the implied right, he said:

Section 2 [of the act] also states that another goal of the statute is to make the control of securities transactions "reasonably complete and effective." If these aims are to be followed by the Act, then, if the investing public is to be completely and effectively protected, section 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges.228

_Pettit v. American Stock Exchange_229 extended _Baird v. Franklin_230 in two respects. In _Pettit_ the trustee in bankruptcy of a company with shares listed on the American Stock Exchange sued the exchange, alleging that its violation of the section 6 duty allowed the consummation of a scheme to defraud the company in connection with shares of its stock issued for insufficient consideration and distributed through a specialist on the exchange. The court held a good cause of action was stated even if the exchange had no knowledge of the violations of its members. The court said the _Baird_ case recognizes a cause of action for negligent violation of section 6, which was sufficiently alleged.

Though the exact pattern of section 6 is not followed in section 15A,231 the NASD is seemingly subject to at least as stern a statutory duty as exchanges and would be liable in a private action where an exchange would be.232 Moreover, the duty of self-regula-

226 Id. at 244.
227 He thus found it unnecessary to consider the force of the plaintiffs' theory that they were third party beneficiaries under § 6(a) (1). Ibid.
228 Id. at 244-45.
230 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
232 The statutory framework supplies a firm base for the clearly desirable answer equating the NASD and the exchanges on this score. Section 15A(b) (8) requires, for registration, that the association's rules be designed "to promote just and equitable principles of trade..." Section 15A(b) (9) also requires that the rules provide for
tors to use reasonable diligence in enforcing should, and probably does, extend to all their rules and requirements.233

C. Violations of Self-Regulatory Requirements As Violations of the Exchange Act or Agency Rules

On the other hand, it seems clear that nothing in the statute causes a violation of a self-regulatory requirement by a member or a listed company to be a violation of the Exchange Act or a Commission rule. Neither the language of section 6(b) nor the policy base of the Baird case justifies the finding that the implied statutory duty of an exchange to use reasonable diligence in enforcement carries with it another implication of a statutory duty on members to comply. Section 6(b) governs the registration of exchanges, not their members. It states that "no registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member. . . ."234 The section orders the Commission to revoke the exchange's registration if the rule is formally deleted. From this, the implication found in Baird was almost compelled, even on the most literal basis; formal deletion and deletion by negligent or willful failure to enforce should be equated.235

Also, the policy pressures for the Baird holding were intense, for if the self-regulators are under no statutory duty to enforce the section 6(b) rule, self-regulation could easily be useless, rendering impossible a system of regulation that is "reasonably complete and effective."236 A failure to find the second implication — that mem-

235 See note 226 supra and accompanying text.
236 See note 228 supra and accompanying text.
bers have a statutory duty to conform — is not as crucial as a failure to find the first implication. So long as the self-regulators must use reasonable diligence to enforce, their rules and requirements have considerable usefulness in the total regulatory framework, even if non-compliance by members and listed companies is not a breach of a statutory duty.

Furthermore, extension of statutory duty in the manner of the *Baird* case to members or listed companies would enlarge the statute for all purposes — implied rights, potential administrative remedies, application for injunctive relief, and criminal penalties. *Baird*, for example, apparently made available to the Commission, as a coproduct, the trio of potential governmental remedies when an exchange fails to use reasonable diligence.\(^\text{237}\)

The consequences illustrate how far removed from the congressional and Commission pronouncements placing self-regulatory requirements outside the sphere of "legal" regulation a finding of a statutory duty would be. For example, it has been assumed that governmental enforcement machinery is not available to move against members violating self-regulatory requirements,\(^\text{238}\) and it would be somewhat odd for the Commission, and not the self-regulators, to have governmental subpoena power to investigate the violations of and to enforce the section 6(b) rule or any other self-regulatory requirement.

**D. Authority of the Commission To Issue Its Own Rules**

The Exchange Act relies upon Commission rules as well as self-regulatory requirements to create an effective pattern of federal regulation. The most important rules governing investor-broker relationships are Rule 10b-5\(^\text{239}\) and the rules under sections 15(c) (1) and (2).\(^\text{240}\) Rule 10b-5 covers all securities transactions (over-the-counter and exchange) of all persons, including broker-dealers.\(^\text{241}\) Rule 10b-5, moreover, does not exhaust the Commission's rule-making authority under section 10(b).\(^\text{242}\) Under section 15(c)

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\(^{237}\) See 2 Loss, *op. cit. supra* note 208, at 1176-78.

\(^{238}\) See, *e.g.*, *Special Study*, pt. 4, at 704.

\(^{239}\) 17 C.F.R. § 240.10b-5 (1964).


\(^{241}\) See notes 44, 52 *supra* and materials cited therein.

\(^{242}\) Exchange Act § 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964). See, *e.g.*, note 52 *supra*; Rule 10b-3 (note 97 *supra*), which incorporates the § 15(c) (1) rules. Two of the latter go beyond the disclosure concept. See 3 Loss, *op. cit. supra*, note 208, at 1474-81.
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(1), which today is not a deeper source of authority in any respect than section 10(b), the Commission can, and has, adopted anti-fraud rules applicable to over-the-counter transactions of all broker-dealers. 243

Implied rights are available for violations of Rule 10b-5 and section 15(c)(1) rules. 244 Under section 15(c)(2), the Commission can and has adopted rules “reasonably designed to prevent” fraud in over-the-counter transactions of all broker-dealers. 245 Violations of section 15(c)(2) rules are, however, excluded from section 29(b) 246 and may, in addition, be excluded from the tort doctrine. 247

In applying the antifraud sections and rules to broker-dealers and other securities professionals, the courts have not limited themselves to common law fraud. A landmark case is Charles Hughes & Co. v. SEC, 248 which rejected such a limitation and held that a broker-dealer impliedly represents that the price of securities sold by him to customers is reasonably related to the current market. Thus, a sale at an unreasonable relationship without disclosure of that fact is a fraud under the statutes. 249 The implied representation theory has come to be known as the "shingle" theory; a broker-dealer, by hanging out his shingle, makes certain implied representations. 250 Other examples of shingle-theory implied representations are that the broker-dealer is solvent 251 and that the broker-

[Notes]

243 See note 242 supra and materials cited therein.
246 See, e.g., SEC Rule 15c2-4, 17 C.F.R. § 240.15c2-4 (1964) (requirement of transmission or maintenance of payments received in connection with underwritings); SEC Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1964) (requirement of favorable suitability determination on certain transactions in which a security is sold and credit is arranged).
249 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1943), discussed in 3 Loss, op. cit. supra note 208, at 1482-93.
250 Ibid.
251 3 Loss, op. cit. supra note 208, at 1482-93.
dealer has a reasonable basis for his recommendations.\(^{252}\) A broker-dealer occupying a fiduciary status must make additional disclosures.\(^{253}\) These overlapping doctrines — shingle and fiduciary status — are still developing.\(^{254}\)

In *SEC v. Capital Gains Research Bureau, Inc.*,\(^{255}\) a 1963 decision, the United States Supreme Court for the first time interpreted the antifraud provisions of the federal securities statutes. The holding is narrow since the Commission was only requesting an injunction compelling a registered investment adviser to disclose, to the subscribers to his service, his practice of purchasing shares for his own account immediately before recommending that security for long-term investment and selling his shares at a profit after the rise following his recommendation. The Commission could have prohibited that practice by means of a rule under a section added to the Advisers Act in 1960.\(^{256}\) However, the Commission preferred to attack the practice under the general antifraud provisions of the Advisers Act.\(^{257}\) The Court, with Mr. Justice Harlan dissenting, reversed a divided Second Circuit (whose opinion had some overtones of the *Chenery*\(^ {258}\) controversy)\(^ {259}\) and ordered the granting of the injunction. The Court followed broad holdings such as the *Hughes*\(^ {260}\) opinion and stated, in language relevant to all of the federal securities statutes, that "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, 'but flexibly to effectuate its remedial purposes.'\(^ {261}\)

\(^{252}\) 3 Loss, *op. cit. supra* note 208, at 1489-90; Duke University School of Law, Conference on Securities Regulation 68-93 (Mundheim ed. 1965).

\(^{253}\) See 3 Loss, *op. cit. supra* note 208, at 1500-08.


\(^{260}\) Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1948).

In Surowitz v. Hilton Hotels Corp., a 1966 decision, the Supreme Court evidenced a liberal, remedial attitude toward the antifraud sections of the Exchange Act and the Securities Act and their private enforcement, though the Court's words were general and in dictum.

When purchases or sales of securities are involved, many self-regulatory requirements could possibly be partially incorporated into Rule 10b-5 via the implied representation route, one widely used in federal securities regulation. A member firm or a listed issuer could be held impliedly to represent that it will adhere to the self-regulator's requirements, at least important ones, thus causing a violation of those requirements to be a violation of Rule 10b-5, absent prior disclosure of departure. Conceptually, this would be a "half-way house," as a violation of law could be avoided by advance disclosure, but the approach would actually come close to incorporating the self-regulatory requirements into the statute. This approach has not been adopted (and it seems not to have been urged), although in an analogous area, the Commission's New York Regional Administrator announced that Commission-registered broker-dealers doing business in New York in violation of that state's net capital requirements would violate the Exchange Act's antifraud proscriptions. As a matter of policy, quasi-incorporation of important self-regulatory requirements into Commission rules — simply because they are self-regulatory requirements — is one of those truly major extensions of the Exchange Act that should require a specific Commission rule under section 10(b).

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262 383 U.S. 363 (1966). The pertinent dictum in the case, id. at 364-66, 373-74 assumes potential significance because of the general similarity between some of the allegations and the allegations in O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), infra note 266, in which the majority held a good claim was not alleged under Rule 10b-5.

263 See notes 249-54 supra and accompanying text.

264 But see note 304 infra (discussion of Rule 11a-1, which appears to make deviation from an exchange "plan" to regulate floor trading a direct violation of Rule 11a-1 (a), unless one of the other exemptions is available).


In two of the leading cases under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), the Second Circuit has refused to be expansive in interpreting Rule 10b-5, while not casting doubt upon the Commission's authority to adopt rules producing a contrary result. See O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), discussed in 3 Loss, op. cit. supra note 208, at 1468-70. Some of the discussion and materials cited in note 52 supra bears upon the Commission's authority under Exchange Act § 10 (b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964).

Before the Supreme Court, the Commission has fared well in situations where it has
Sections 15(b)(8) to (10) round out the most important parts of the relevant statutory pattern. These sections are compromise provisions growing out of the Commission’s proposal in the legislative program culminating in the 1964 amendments that all registered broker-dealers be subjected to two-layer regulation by the Commission and the NASD. Congress rejected the Commission’s request that NASD membership be required. Congress did, however, (1) authorize sufficient additional Commission rule-making powers over non-NASD members so that there would be little difference in total regulation of members and non-members, and (2) direct the Commission to assess fees on non-members substantially equal to the fees assessed by the NASD on its members. Section 15(b)(10) authorizes, for example, rules “designed to promote just and equitable principles of trade...” Under this authority, the Commission can go beyond a requirement of full disclosure. Disclosure versus prohibition describes, in general, the difference between the Commission’s antifraud authority and a just-and-equitable-principles requirement. Given the remedial interpretations of the antifraud sections, the Commission has considerable flexibility in defining material facts and in determining when a preferred to move case-by-case (either in its own administrative proceedings or in applications for court action) rather than issue rules. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); SEC v. Chenery Corp., 322 U.S. 194 (1947), and text accompanying note 146 supra. For a discussion of the Commission’s practice and philosophy on rules versus case-by-case expansion, see Cohen & Rabin, supra note 254. For a discussion of that subject covering administrative agencies in general, see Shapiro, The Choice of Rulemaking or Adjudication in the Development of Administrative Policy, 78 HARV. L. REV. 921 (1965).

However, extension of the Act by judicial quasi-incorporation of self-regulatory requirements into Rule 10b-5 would reach conduct far beyond the current general contemplation of the reach of the Rule, and unlike the basing of an implied right directly upon a breach of a self-regulatory requirement, such an extension would broaden the act for all purposes. This is, of course, not to say the Commission could not adopt such a rule or that conduct violating a self-regulatory requirement will not often independently violate a Commission rule.

The type of quasi-incorporation outlined in the text would appear to create no substantial problem of improper delegation of powers to a private group, as it would be the failure to disclose in advance the departure from the self-regulator’s requirement, rather than the departure, which would violate Rule 10b-5 and the act. The implied representation that certain rules of a self-regulatory organization will be followed would be considered a material fact, and material facts under the antifraud provisions of all of the federal securities statutes are created by the actions of private parties. See also note 289 infra.

broker-dealer or company is under a fiduciary duty to disclose, but under sections 10(b)270 and 15(c) (1), it is conceptually difficult to prohibit fully disclosed practices, though in fact this has sometimes been done.271 Under a just-and-equitable-principles standard or under section 15(c) (2), which authorizes rules reasonably designed to "prevent" fraud, absolute prohibitions can be imposed.272 This difference is, however, often a thin one, as the required disclosure may be so sharp that the undesirable practice to be disclosed will be discontinued.273

Sections 15(b) (8)-(10) contain a heavy legislative history gloss requiring Commission regulation and fees thereunder to be substantially comparable to NASD requirements.274 Though the legislative history is silent, the violation of section 15(b) (10) rules seemingly will create implied private rights of action. Arguments to the contrary are that the rules, though legal requirements, will embody ethical rather than antifraud concepts275 and that implication would be inconsistent with the comparability gloss, assuming there are no implied rights for violation of self-regulatory requirements. Private rights have, however, been implied under several provisions of the Exchange Act that have little to do with fraud. Violations of the margin rules are the best example.276 It furthermore seems almost impossible for the comparability gloss to override the clear applicability of section 29(b), and in any event, the comparability gloss can be carried only so far. For instance, comparability cannot take from the Commission its traditional enforcement remedies — criminal reference, application for injunctive relief, and administrative proceedings under section 15(b) (5)277 against the registration — none of which is

271 See note 242 supra.
272 SEC Rule 15c2-4, 17 C.F.R. § 240.15c2-4 (1964) (transmission or maintenance of payments received in connection with underwritings); SEC Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1964) (favorable suitability determinations required on sales of securities when arranging certain types of credit).
273 For example, the investment adviser dealing with a client as a securities dealer must disclose capacity, cost, and best available market price (if more favorable to the client than the proposed price). See 3 LOSS, SECURITIES REGULATION 1500-08 (2d ed. 1961). These disclosures prevent unreasonable markups.
275 See Mundheim, supra note 254, at 468-69.
available either to the Commission or to the NASD for violations of NASD rules. 278

If private rights are implied for violations of section 15(b) (10) rules (which by definition will be applicable only to non-NASD members) and none or only a few are implied for violations of NASD rules, the discrimination will be anomalous. Any such anomaly can, however, be rationalized as a result almost inevitably flowing from the compromise adopted in the 1964 amendments.

II. SOME CONSIDERATIONS OF CONSTRUCTION AND POLICY

A. In General

Since, as has been already discussed, violations of self-regulatory requirements are not illegal conduct violating the Exchange Act, one possible basis for extension of implied rights is eliminated. Another possible basis for extension is also ruled out since quasi-incorporation into Rule 10b-5 of violations of important self-regulatory requirements, solely because of the self-regulators' commands, seems, as a matter of policy, improper absent a specific Commission rule.

How then can an implied right under the Exchange Act be created? Section 29(b) voids only contracts made in violation of the Exchange Act or agency rules. Despite the integral and crucial role played by the self-regulators in the implementation of the Exchange Act, it carefully distinguishes between the rules of governmental agencies and self-regulatory requirements. The act does not make the violation of a self-regulatory requirement unlawful or a crime; nor does it authorize the Commission to seek injunctive relief to enforce self-regulatory requirements or to impose an administrative sanction for their violation. Nor does the Exchange Act give the self-regulators governmental subpoena power.

Section 16(b), 279 of course, creates a civil liability based on conduct that requires no showing of illegality, but section 16(b) is also a congressional enactment. Should the courts — as opposed to Congress — press beyond section 29(b) and the tort doctrine where there is a violation of law? In one very important sense, federal jurisdiction has not to date been extended by the courts in

278 See Phillips & Shipman, supra note 268, at 826-27.
the implied rights area, for the courts have acted to effectuate congressional purposes only after Congress has extended the statute (or the Commission has exercised its rulemaking power) to provide a federal, uniform legal base of investor protection in matters such as proxy solicitation (section 14)\(^{280}\) or in the purchase or sale of any security by any person (section 10(b)). The extension of the Exchange Act by Congress — or by the Commission, using congressionally created and delegated rule-making powers — has set the standard and made available the governmental enforcement sanctions. Judicial implication of a private right of action for the unlawful conduct gives investors — for whose protection the Exchange Act is primarily designed — a remedy when the extant congressional directive (extension) is not honored and they are damaged and have no administrative recourse for damages. Implication of rights in the absence of a violation of the Exchange Act or Commission rules would often effectuate congressional purposes, but by furnishing a private remedy where the government would have no sanction, something closer to a true judicial extension of federal jurisdiction would be present.

But in many cases considerations of fairness and effectuation of the purposes of the Exchange Act will strongly support creation of an implied right. Nothing in the legislative history seems to prohibit the creation of implied rights for violations of self-regulatory requirements.\(^{281}\) As expertly and forcefully pointed out by Mr. Lewis D. Lowenfels of the New York Bar in a recent article,\(^{282}\) extension of implied rights would add to the storehouse of investor pro-

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\(^{281}\) The NYSE did, in the 1934 Senate Hearings, make a proposal (not adopted) that it be allowed to promulgate two classes of rules concerning the listing of securities — one with, and the other without, the force of law. Those with the force of law would have been effective upon Commission approval, and the Commission could have directed the making of such rules. Hearings on Stock Exchange Practices Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. pt. 16, at 7522 (1934).

tections. The Second Circuit's opinion in Colonial Realty Corp. v. Bache & Co.,\textsuperscript{283} notes that the question of the implication of a private right is difficult because of the unique statutory scheme of self-regulation, and because the effect and significance of particular rules may vary with "the manner of their adoption and their relationship to provisions and purposes of the statute and SEC regulations..."\textsuperscript{284}

In addition, — and this is important — extension of federal jurisdiction to create an implied right based on a violation of a self-regulatory requirement might remove the need for an even greater extension of federal jurisdiction by the Commission. If, for example, it appears to the Commission that investors should have a private right of action for violation of a self-regulatory requirement, the Commission in many areas can effectively incorporate the requirement or a similar one into its own rules.\textsuperscript{285} That action, however, extends federal jurisdiction for all purposes and downgrades the importance and autonomy of the self-regulators far more than a judicial extension of a liability-only duty to comply with the self-regulatory requirement.

J. I. Case Co. v. Borak,\textsuperscript{286} of course, placed primary emphasis upon the effectuation of congressional purposes and eschewed a narrow, technical approach to implied rights. The congressional purpose of investor protection flows throughout the two-tier Commission and self-regulatory structure created by and operated under the Exchange Act. The conceptual step from implication for violations of sections such as 14(a) and 10(b) and the Commission's rules under them to implication for violations of self-regulatory investor-protection requirements can be taken without much difficulty, once a policy judgment is made. In either case, interstitial judicial legislation is involved — only the extent differs. Section 27\textsuperscript{287} furnishes jurisdiction, \textit{inter alia}, for suits and actions to enforce any "liability" or duty created by the Exchange Act.\textsuperscript{288}

\textsuperscript{284} Id. at 181.
\textsuperscript{285} See notes 241-66 \textit{supra} and accompanying text.
\textsuperscript{286} J. I. Case Co. v. Borak, 377 U.S. 426 (1964).
\textsuperscript{288} Lowenfels, \textit{supra} note 282, points out the failure of the district court in the Colonial Realty case to discuss this part of § 27, which was relied upon by the Supreme Court in the Borak case. The Second Circuit's opinion in Colonial Realty deals with this portion of § 27. See note 374 \textit{infra} and accompanying text.
pervasive federal control of the self-regulators and of securities transactions and the unique reliance upon self-regulation to aid in the protection of investors could be considered sufficient to warrant an extension of the tort doctrine beyond Borak and Baird to conduct not violating the law.\textsuperscript{289} The Exchange Act would have created

\textsuperscript{289}In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the Court had before it alleged violations of the proxy rules and § 14(a), the source of the Commission's rulemaking power. The Court felt this squarely fitted in the language in § 27 giving the district courts jurisdiction of all suits in equity and actions at law "to enforce any liability or duty created" under the Act. However, the liability or duty found under the Act in any implied rights case (especially when § 29(b) is not being applied) is created in part by the Act and in part by the courts. The desirability of judicial implication in Borak was based upon the broad, remedial purposes of § 14(a), the fact that one of the chief purposes of § 14(a) was the protection of investors, and the "necessary supplement" to Commission action that private enforcement of the proxy rules would provide. The Court said that under the circumstances before it, "it is the duty of the [federal] courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." \textit{Id.} at 433. See notes 9-17, 87-92, and 171 \textit{supra} and accompanying text. In many cases, all of the elements present in \textit{Borak} would be present where self-regulatory requirements are violated, except that there is no violation of the act or Commission rules. Investor protection and the promotion of optimum reliance upon the self-regulators — two leading congressional purposes — would often be served by implication of private rights. The question is whether some self-regulatory requirements are to be equated with the act or Commission rules.\textsuperscript{2} In applying the tort doctrine, congressional intent on implied rights has generally been considered immaterial, absent a strong negative intent. See notes 131-34 \textit{supra} and accompanying text. The jurisdictional language in § 301 is also more explicit than § 27, although § 27 is broad and is not limited to express private rights and once the implied right is created, § 27 readily fits. See notes 46-47 \textit{supra} and accompanying text.


Equation of certain self-regulatory requirements with Commission rules solely for purposes of implied rights under the act would seemingly raise no substantial question concerning improper delegation of powers to a private group, as governmental sanctions would not be involved. The Exchange Act would be affecting the private rights of investors and broker-dealers in a manner Congress apparently could expressly impose. Cf. Textile Workers Union v. Lincoln Mills, \textit{supra}. See also R. H. Johnson & Co. v. SEC, 198 F.2d 690 (2d Cir.), \textit{cert. denied}, 344 U.S. 855 (1952).

Blaney v. Florida Nat'l Bank, 31 U.S.L. \textit{Week} 2524 (5th Cir. March 7, 1966) held that a complaint alleging a breach of fiduciary duty by a bank through violation of an FRB regulation requiring conformance to sound principles in operation of trust departments does not state a federal cause of action. The court distinguished \textit{Borak} on the grounds of the broader scope of § 27 of the Exchange Act and of the lack in the FRB regulations of the broad remedial purposes of the Exchange Act. The court also felt that the law of trusts and estates is primarily a matter of state concern.

There appear to be few decisions discussing the application of the tort doctrine to standards contained in sources other than statutes or rules of administrative agencies. The cases under state law on exchange rules are discussed in the text accompanying notes 325-39 \textit{infra}. A valid rule of a court is commonly said to have the force of law.
a liability, but the governmental enforcement machinery would not be enlarged. This technique — finding what might be labeled a "liability-only duty" to comply with self-regulatory requirements — would extend Baird solely for the purposes of implied rights under the act. Such a limited extension would be far preferable to quasi-incorporation into the Commission's rules by judicial action.

Another threshold question is whether any liability-only duty would be limited to a duty to exercise reasonable diligence to comply with the self-regulator's requirements, since an exchange need do no more than use reasonable diligence in enforcement? A limitation to reasonable diligence would provide a tolerance and would arguably be required by analogy to the Baird case. The Exchange Act, however, in several places distinguishes between the duties of supervisory personnel and controlling persons on the one hand and actors on the other, and limitation of the duty to reasonable diligence might not be imported from Baird.290

B. Special Considerations Concerning Various Categories of Self-Regulatory Requirements

Special considerations seem to be presented by several of the various categories of self-regulatory requirements. There are two persuasive arguments for finding an implied right for violations of the section 6(b) rule.291 The rule is directly required by the Exchange Act, and section 29(a)292 voids any "provision binding any person to waive compliance with any provision of [the act or any rule or regulation thereunder], or of any rule of an exchange re-

on matters such as attorney's compensation. See, e.g., Weil v. Neary, 278 U.S. 160 (1929). Cf. Archer v. Griffith, 390 S.W.2d 735 (Tex. Sup. Ct. 1964). The force of the canons of ethics of voluntary bar associations is discussed in DRINKER, LEGAL ETHICS 26-30 (1953), where the author notes that the decisions are not entirely clear. This is partially because so much of the conduct condemned by the canons would be considered contrary to public policy in any event. In Talley v. Alton Box Bd. Co., 37 Ill. App. 2d 137, 185 N.E.2d 349 (1962), the court seemed to depart from earlier Illinois cases in holding that the canons can have considerable force.

In negligence cases, company rules are often admitted as an admission of perception of risk and appropriateness and feasibility of precautions. 2 HARPER & JAMES, TORTS 980-81 (1956).


291 See text accompanying notes 186-87 supra.

quired thereby....

The voiding of a waiver of compliance forcefully suggests the presence of an implied right of action for a violation of the section 6(b) rule. But perhaps the intent was to prevent the exchanges from obtaining binding waivers of liability for losses resulting from their failure to enforce. In any event, section 29(a) is not applicable to any NASD rule, and the desirability of parallel treatment of exchange and NASD members for violation of the section 6(b) rule would be a strong reason for disregarding section 29(a) in determining whether there is an implied right.

One of the most telling arguments against implication for violations of the section 6(b) rule is its breadth, depth, and generality. Implication for violations of that rule would transform the governing standard of liability at the federal level from one of fraud to one of ethics and of fairness. Granted that the difference between the antifraud authority of the Commission and the just-and-equitable-principles standard is not large at this time and that notions of proper ethics and fiduciary duties play a large part in determining what is fraudulent under existing Commission rules, the change from those existing Commission rules to "just and equitable principles" is substantial. Such a change would indeed, considering the generality of the section 6(b) rule, require the application of a body of general federal contract and tort law to relations between broker-dealers and their customers.

Yet, "just and equitable principles of trade" is a concept that

283 Ibid. (Emphasis added.) Section 29(a) is discussed in 3 Loss, op. cit. supra note 273, at 1811-17.

284 Cf. 3 Loss, op. cit. supra note 273, at 1836 n.502 (1961 & 1962 Supp.); Texas & Pac. Ry v. Rigsby, 241 U.S. 33 (1916). In Rigsby, a Safety Appliance Act case, the Court's creation of an implied private right of action in favor of an injured workman was based in large part upon the statement in the statute that an employee injured by any car, etc., in use contrary to the statute shall not be deemed to have assumed the risk. The Safety Appliance Act cases are analyzed in 2 Loss, op. cit. supra note 273, at 989-93.

In Brown v. Bullock, 194 F. Supp. 207, 237-38 (S.D.N.Y.), aff'd without consideration of the point, 294 F.2d 415 (2d Cir. 1961), the court, in finding an alleged implied private right of action under the Investment Company Act, relied in part upon provisions voiding exculpatory clauses relieving officers, directors, and investment advisers of liability for certain conduct. The court considered non-waiver and non-exculpatory provisions as necessarily indicating liability for acts within a non-exculpatory direction or for acts violating a statutory duty, the performance of which cannot be waived.

285 See text accompanying notes 241-78 supra. It has been suggested that the term "just and equitable principles of trade" was included in §§ 6(b) and 15A(b) because of its stock exchange history, Natl. Assn. of Sec. Dealers, Inc., 19 S.E.C. 424, 484 (1955) (dissenting opinion of Commissioner Healy). But see § 15A(h) (1) (notes 297-98 infra and accompanying text) and § 15(b) (10).
the Commission and the courts have applied and will apply in a number of contexts. In section 15(b)(10) Congress did not view the just and equitable standard as too vague to be placed in the statute as a basis for Commission rules. Under section 15A(h)(1), the Commission must, in every review of NASD disciplinary proceedings, declare whether the conduct violates just and equitable principles. Twenty-five years of experience and precedent have accumulated under that section. Under sections 15A(b)(3) and (4), certain exchange disciplinary actions involving violations of just and equitable principles and other exchange rules can form the basis for exclusion from NASD membership. Moreover, in Baird and the cases that followed it, courts necessarily have been willing to determine whether the alleged conduct of members violated just and equitable principles.

If the Commission has its own direct rule-making jurisdiction, but has deferred to the self-regulators, should violations create implied rights regardless of the conclusion in other areas? For example, section 11 authorizes Commission rules regulating specialists' activities and floor trading by members for their own account. In both areas, the Commission has issued rules within the last two years. Though the Commission's rules create a framework of detailed regulation, they do so indirectly, in that the Commission's rules, for the most part, only specify what provisions the rules of the exchange must contain.

Section 14(b), which was strengthened and expanded by

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298 See 2 Loss, op. cit. supra note 273, at 1374-80.
300 See Phillips & Shipman, supra note 268, at 829-32.
301 See Judge Clark's opinion in Baird v. Franklin, 141 F.2d 238, 240 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
304 Under Rule 11a-1, however, a floor trader violating the "plan" of the exchange violates Rule 11a-1(a). Rule 11b-1 establishes its own intricate framework for changes in applicable exchange rules and for limited Commission disciplinary action against specialists deviating from the exchange rules; both Commission powers go beyond its usual statutory authority. This deep Commission involvement in administration could cause the applicable exchange rules to be considered de facto Commission rules.
the 1964 amendments, authorizes Commission rules governing the
voting by broker-dealers of street name securities registered on an
exchange or under section 12(g)\(^{308}\) and the transmission of ma-
terials to the owners of such securities.\(^{307}\) The Commission has not
issued rules, apparently relying upon the comprehensive rules of
several of the exchanges.\(^{308}\)

The deference under section 11 is not as major as it might
seem, for the conduct of specialists and floor traders remains sub-
ject to Rule 10b-5.\(^{309}\) The deference under section 14(b) has
posed one problem; the courts have ignored, in election review pro-
ceedings, alleged violations of the NYSE rules by a member firm in
voting street-name securities.\(^{310}\) If the NYSE's requirements were
incorporated into a Commission rule, \textit{Borak} would apparently dic-
tate that violation would in appropriate cases require a voiding of
the broker-dealer's illegal vote and perhaps other suitable relief.

A second special category of self-regulatory rules consists of
those added by Commission alteration or supplementation.\(^{311}\) Such
a rule is not governmental. Under section 19(b),\(^{312}\) the Commis-
sion is not authorized, for example, to promulgate its rule establish-
ing exchange commission rates. It can move only by changing the
exchange's rules in accordance with the specified standards and pro-
cedures. Such self-regulatory rules are, however, similar to the sec-
tion 6(b) rule in that both are directly required by the government — the section 6(b) rule by the statute and the other type of rule
by the Commission under statutory discretion granted it. An ex-
change rule added by a section 19(b) proceeding (there has been
one proceeding) apparently fits within the non-waiver stipulation
of section 29(a) as a rule of the exchange required by the Exchange
Act or Commission rules.\(^{313}\) Furthermore, such an exchange rule

\(^{308}\) Exchange Act § 12(g), 48 Stat. 892 (1934), as amended, 15 U.S.C. § 78l(g)
(1964).

\(^{307}\) See 2 Loss, \textit{op. cit. supra} note 273, at 924-30; Lowenfels, \textit{supra} note 282, at
25-28; Phillips & Shipman, \textit{supra} note 268, at 789-95.

\(^{309}\) Ibid.

accompanying note 229 \textit{supra}.

\(^{310}\) See 2 Loss, \textit{op. cit. supra} note 273, at 928; Lowenfels, \textit{supra} note 282, at 26.

\(^{311}\) See note 208 \textit{supra} and accompanying text.

(1964).

\(^{313}\) See 3 Loss, \textit{op. cit. supra} note 273, at 1812; 2 Loss, \textit{op. cit. supra} note 273, at
1179-83. Where the Commission alters the rule of the exchange through a Commission
probably cannot be amended or revoked without Commission consent.\(^3\)\(^1\)\(^4\)

Where the Commission has deferred to the self-regulators or has altered or supplemented exchange rules, persuasive arguments for implied rights can be made. On the other hand, as discussed below in the analysis of the *Colonial Realty* opinion, there are difficulties in attempting to attach special importance to rules in the "deference" category.\(^3\)\(^1\)\(^5\)

Two additional categories of self-regulatory requirements remain. Self-regulatory "housekeeping rules," as labeled by Mr. Lowenfels, should, as he points out, never form the basis of implied rights.\(^3\)\(^1\)\(^6\) These rules — easier to label as a category than to identify on a rule-by-rule examination — have insubstantial investor-protection motivation. An example of such a rule is the NYSE rule concerning transfer of seats.\(^3\)\(^1\)\(^7\) The insubstantial investor-protection purpose should preclude implied rights, even assuming that requisite causation from a breach could be found.\(^3\)\(^1\)\(^8\) A number of self-regulatory rules fall into this category, although, because one of the primary functions of the self-regulators is investor protection, it may be difficult in examining any particular rule to find the investor-protection motivation to be insignificant.

Section 28(b)\(^3\)\(^1\)\(^9\) seems to uphold the exchange rules governing the settlement of disputes between members, so that implied rights would never be available as between members in contravention of exchange procedures to settle such disputes.\(^3\)\(^2\)\(^0\)

Of vital importance are the consequences of the implication of private rights under the Exchange Act on the zeal and effectiveness of the self-regulators. The implication of private rights would probably not cause repeal of existing rules, but would it cause a reluc-
tance to adopt needed new rules? Where the choice is between the possibility of implied rights for member violations of self-regulatory rules or a Commission rule covering substantially the same ground, there probably would be no substantial reluctance. And as discussed in part I, rules can provide any tolerances that may be necessary. The implication of private rights would perhaps make it more difficult for the self-regulators to maintain the optimum autonomy of which the Special Study speaks, but, again, it may often be preferable for a private right to be based on violation of a self-regulatory rule than for a Commission rule to occupy the field.

III. EFFECT UNDER STATE LAW OF VIOLATIONS OF SELF-REGULATORY REQUIREMENTS

Under state law, a customer of a securities or commodities broker-dealer is usually held subject to the established customs and usages of the exchange or market in which the broker-dealer regularly deals, whether or not the customer knows of them. But the customer is seldom given the benefit of a tort or implied contract doctrine when his broker-dealer violates the rules of an exchange to which it belongs and damages the customer, although

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321 Section 15A(j) prevents the NASD from, inter alia, repealing existing rules if the Commission disapproves. No similar power is spelled out concerning exchanges. But see notes 206-08 infra and accompanying text. Also, § 6(b) prevents changes in the § 6(b) rule.

322 See text accompanying notes 154-55 supra.

323 See notes 151-55 supra and accompanying text.

324 Special Study, pt. 4, at 692-728.

325 See, e.g., Jackson, Stockbroker's Liability Under Customs, Usages, and Rules, 12 CLEV.-MAR. L. REV. 111 (1963); 3 Loss, op. cit. supra note 273, at 1812 n.427 (1961 & 1962 Supp.) and materials there cited. But cf. Hyman v. Sachs, 194 Misc. 69, 86 N.Y.S.2d 237 (Sup. Ct. 1948), aff'd mem., 275 App. Div. 804, 89 N.Y.S.2d 608, aff'd, 300 N.Y. 499, 89 N.E.2d 20 (1949). A customer was found to have given no implied consent to be governed by NASD rules, since the NASD was not as well known as the exchanges. The statement on the confirmation that transactions in unlisted securities were subject to usages and customs among dealers in unlisted securities did not, the court said, incorporate NASD rules, because rules of the NASD are not usage or custom. In light of the growth in importance and recognition of the NASD since 1948, a different result might be reached today.

Margin account clauses and confirmations may expressly state or clearly imply that transactions are "subject to" the "rules," as well as the customs and usages, of the NASD and other self-regulators. See materials cited note 336 infra and text accompanying that note. See also note 326 infra.

326 See, e.g., 3 Loss, op. cit. supra note 273, at 1812 n.427 (1961 & 1962 Supp.); Jackson, supra note 325, at 115. But cf. Watkins Grain Co. v. Fraser Smith Co., 221 Iowa 1164, 267 N.W. 115 (1936) (on question of scope of authority of customer's employee, breach of rule of commodities exchange of which broker was a member that
nothing in the Exchange Act prevents grounding investor remedies under state law upon violations of self-regulatory requirements.\textsuperscript{327}

written authorizations be obtained from customers was given weight by court in finding no actual or apparent authority).

An exchange rule may give discretion to a member in certain matters, in which event it may be difficult to show a violation of the rule. See Jacobs v. Hyman, 286 Fed. 346 (5th Cir. 1923) (rule of a commodities exchange permitted, but did not require, the closing of an account when margins were exhausted; delay in closing by the member not a violation of the rule). To the same effect is Du Pont v. Neiman, 156 Cal. App. 2d 313, 319 P.2d 60 (1957), another commodities case. In Du Pont, the court held alternatively that "it is manifest that the rules of a trading exchange cannot have the effect of a statutory enactment, and therefore cannot of their own force inject illegality into the transaction." One of the applicable exchange rules contained a negation clause providing that the failure of a member to close a customer's account as required shall not relieve the customer of any liability to the member.

A leading New York case holding that a violation of the rules of a commodities exchange does not give the customer a cause of action is Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715 (1955), aff'd per curiam, 284 App. Div. 870, 134 N.Y.S.2d 590 (1954). See also Irving Weis & Co. v. Offenberg, 31 Misc. 2d 628, 220 N.Y.S.2d 1001 (1961) (action by securities broker against customer, in which alleged violation by former of FRB margin rules was asserted as a defense and counterclaim; defense and counterclaim denied on several grounds, with heavy reliance in dictum on Nichols, supra); Whyte v. New York Mercantile Exch., 36 Misc. 2d 745, 233 N.Y.S. 2d 37 (1962) (court cited Nichols and Weis, supra, with approval, though in dictum as the court did not find a violation of the rules of the exchange). Klein v. D. R. Comenzo Co., 207 N.Y.S.2d 739 (1960), gave an unusual effect to the FRB's margin rules. In an action by a customer against his broker concerning a contract to purchase stock, the contract was held unenforceable because it obviously contemplated extension of credit in violation of those rules. Concerning the assertion in state courts of defenses provided by the act, see note 340 infra.

Klein, supra, is distinguished in Myer v. Shields & Co., 267 N.Y.S.2d 872 (App. Div. 1966), which held that a customer who has violated the FRB's margin rules, but who has paid for his stock in full, is entitled to receive the stock from the broker despite any unlawful credit arrangements. The court viewed the dominant purpose of the margin provisions as the protection of the small speculator, and noted that Klein, supra, did not state the facts or attempt to deal with the remedial purposes of the margin rules.

A good review of the authorities on the effect of exchange rules on customers and interesting dictum concerning the effect of violation by a member are contained in White v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 218 A.2d 655 (N.J. Super. Ct. 1966). This was a suit by an investor to recover money paid for debentures that proved to be of questionable value. Plaintiff placed his order with the defendant on February 26, 1963, and the debentures, listed on the American Stock Exchange, were purchased the same day. The exchange suspended trading the next day, and a few days later delivery was made and payment received. The court held that if the practices and rules of the exchange prevented the defendant from cancelling the order after its execution, the plaintiff cannot complain — "unless these practices are so repugnant to common principles of equity and fair dealing as to compel the court to redress his grievances." But, said the court, had there been a showing that it was incumbent upon the defendant under the rules to cancel the transaction, "plaintiff would have a proper cause of action." The opinion is not clear as to whether the defendant purchased the debentures on the exchange or in the over-the-counter market.

Rospigliosi v. Clogher, 46 So. 2d 170 (Fla.), cert. denied, 340 U.S. 833 (1950) discussed in note 340 infra and accompanying text, and Gaynor v. Buckley, 318 F.2d 432 (9th Cir. 1963), discussed in notes 342-43 infra and accompanying text, contain implicit holdings refusing to give effect, under state law, to alleged violations of NYSE requirements.

\textsuperscript{327} See notes 398-402 infra and accompanying text.
The discrimination in the one-way approach seemingly has not appeared unfair to courts applying state law, even though broker-dealers (especially NYSE members) may display and advertise their exchange memberships. Allocated violations by NYSE member firms of its rules concerning voting of street-name securities have also been considered immaterial in review proceedings.

In related settings, courts have sometimes given effect to self-regulatory requirements. A New York decision denied brokerage commissions to a NASD member on transactions executed during his suspension from the NASD, although the Exchange Act does not require this result. The court reasoned that the sanction was needed to make the suspension effective. Another New York decision held that a former registered representative of a NYSE firm could compel the firm to arbitrate, rather than litigate, its claim against him for his allegedly slanderous remarks concerning the firm while he was in its employ. The court found that this result was required by the NYSE rules which require a member to arbitrate disputes with nonmembers arising out of its business, if the nonmember so requests. The Maryland Court of Appeals has indicated, in dictum, that some covenants made by a company in an exchange listing agreement may be enforceable by a shareholder as a third party beneficiary.

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328 As discussed in notes 248-54 and 263-66 supra and accompanying text, the implied representation approach has been widely used in federal securities regulation. From a display and advertisement of memberships in self-regulatory bodies, it would appear fairly easy to find an implied representation of adherence to important investor-protection rules.

329 See materials cited note 310 supra.

330 Boruski v. National Sec. & Research Corp., 237 N.Y.S.2d 772 (App. Div. 1962). Under the act and the NASD rules, the only effect of an NASD suspension at that time was to trigger the NASD rules concerning member dealings with nonmembers. See 2 LOSS, SECURITIES REGULATION 1369-70 (2d ed. 1961). At the present time, suspension may in addition subject the broker-dealer to §§ 15(b)(8)-(10), discussed in text accompanying notes 268-78 supra. The discussion in the brief opinion does not rule out the possibility that the NASD rules concerning member dealings with nonmembers may have been relied upon by the defendant.


332 Ibid.

333 Mackubin v. Curtiss-Wright Corp., 190 Md. 52, 57 A.2d 318 (1948). Defendant's shares were listed on the NYSE, and its listing agreement required prompt disclosure of dividend action. On March 6, 1946, plaintiff purchased 200 shares and placed a limit order to purchase additional shares at $30. The Board met late in the afternoon on March 18 and voted to omit the usual quarterly dividend. Apparently due to inadvertence, no announcement was made until 2:30 P.M. the next day. The price then rapidly fell from its level of 31 1/4 before the announcement to below $30. Plaintiff's order was executed at $30. The court held plaintiff's claim was as a prospective shareholder, although she al-
Furthermore, the action of the Baltimore City Circuit Court in the *United Funds, Inc. v. Carter Prods. Inc.* case in finding (in a statement in a prospectus) and enforcing an implied management promise that it would not, absent a good business reason, take steps causing the NYSE to delist the company's stock is a landmark in recognition and fostering of federal investor protections under state law.  

Most intriguing is the possibility of a bilateral incorporation of exchange and NASD rules in the contractual relationship of members and their customers. Margin account agreements and the reverse side of confirmations often state that transactions are subject to applicable governmental and self-regulatory requirements. The motivation of broker-dealers is probably to protect themselves when, for example, the Commission or the exchange suspends trading or the latter cancels stop-loss orders, and the wording of the clauses seemingly attempts to make incorporation a one-way street. However, in a recent unreported federal district court case, the plaintiff alleged that such a clause in a margin account agreement effected bilateral incorporation and that the defendant firm, a NYSE member, violated NYSE rules to his detriment; the court held this presented a cause of action. Obligation through contractual incorporation under state law is or may be different in three respects from implying a right under the Exchange Act. First, the scope of the Exchange Act is not enlarged in that there is no newly found duty of compliance for any purpose. Second, state law will govern the extent and effect of contractual incorporation and that under New York law, accepted as governing, the listing agreement was not intended for the benefit of prospective purchasers. The court left open the question of third party beneficiary rights as a shareholder.

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338 See *Folsom v. Townsend, Dabney & Tyson*, Civil Action No. 7-199 (D. Maine Dec. 20, 1963) (oral opinion). The allegations of violations of NYSE rules constituted the second count, the first being an allegation of violations of the FRB's margin rules. See also note 326 *supra*. On incorporation, see also Wilko v. Swan, 346 U.S. 427, 433 n.18 (1953), discussed in text accompanying notes 387-93, 412-14 *infra*. If there is two-way incorporation as a matter of state contract law, the incorporation would seem to extend to federal and state governmental requirements, because of the sweeping language used in the clauses. *Cf.* 2 Loss, *op. cit. supra* note 330, at 996-99; 3 id., at 2005-06; text accompanying notes 396-402 *infra.*
ration. Third, section 29(a) will not prevent the broker-dealer from enforcing a pre-controversy agreement to arbitrate customer claims of damage from violations of self-regulatory requirements.\(^{339}\)

IV. PRE-COLONIAL REALTY CASES ON IMPLIED RIGHTS UNDER THE EXCHANGE ACT

The Florida Supreme Court has considered the effect of a NYSE rule forbidding its members or their representatives from having an interest in customers' accounts.\(^{340}\) The plaintiff, a registered representative of a NYSE firm, sued his alleged common-law wife for his interest in an account carried in her name, maintaining that, pursuant to an agreement between them, he had a part interest. The defendant argued that the plaintiff's violation of the NYSE rule prevented his action and that any agreement by her was voided by section 29(a). The court, without mentioning \emph{Baird}, held that sections 6(b) and 29(a) were inapplicable, as the rule in question was not one required by the Exchange Act. The court construed the Exchange Act as requiring an exchange to have only one rule — discipline for violation of just and equitable principles of trade — and as allowing an exchange, within limits, to have any number of other rules. The court seemed to believe that civil remedies under the Exchange Act would flow from the violation of the one required rule, but held that none would flow from the violation of others.

In \emph{Walsh v. Peoria & E. Ry.},\(^{341}\) an insurgent solicitor of proxies alleged that NYSE member firms wrongfully failed to forward his material to beneficial owners of street-name stock. Since the court found an alleged violation of the Commission's proxy rules, it did not decide whether a violation of the applicable NYSE rule would create an implied private right of action, although it said the question was "more doubtful."

Several recent cases have touched upon the availability of private rights where issuers or their managements are alleged to have

\(^{339}\) See note 353 \textit{supra} and accompanying text.


The court did not mention the declaration in § 27 that only the federal courts have jurisdiction of claims under the act. Where, however, the act is raised as a defense, as it was, state court jurisdiction is proper and desirable. \(^{341}\) See 2 \textit{Loss}, \emph{op. cit. supra} note 330, at 977-86. \textit{Cf.} notes 398-402 \textit{infra} and accompanying text.

violated NYSE requirements. In Gaynor v. Buckley, where diversity jurisdiction was present, shareholders in a derivative action attempting to set aside the grant of a stock option to an employee of a listed company alleged, among other grounds, the violation of a NYSE requirement. The Ninth Circuit dismissed the contention with the observation that "the New York Stock Exchange does not legislate for the state of Georgia [the state of incorporation]."

In Kroese v. New York Stock Exchange, a holder of sub-share certificates of proprietary interest in the Texas Pacific Land Trust sued the Trust and the NYSE (on which trust certificates are listed), alleging that the former was in violation of a requirement or policy of the NYSE that listed issuers hold regular meetings of owners, which, under a clear NYSE policy, would require solicitation of proxies. Finding no NYSE rule or requirement of regular meetings, the court dismissed the complaint. The court, however, seemingly agreed that the Baird duty of the exchange extended to requirements concerning issuers and seemed to have no problem with the joinder of the issuer.

Finally, O'Neill v. Maytag, decided by the Second Circuit after the district court's decision in Colonial Realty, was a chilly reception to implied rights under the Exchange Act against managements for violation of NYSE requirements. The plaintiff in a shareholders' derivative action alleged that the management of a listed company had caused it to purchase a large block of the company's own stock for an amount considerably in excess of its then market value in order to protect management's position. After holding that the complaint stated no implied right of action under Rule 10b-5 or section 409(b) of the Federal Aviation Act, the court dealt with the district court's refusal to allow the plaintiff to amend his complaint to set forth a cause of action under the Ex-

342 318 F.2d 432 (9th Cir. 1963). It is not clear whether the alleged violation of NYSE rules was asserted as a claim under the act or under state law.

343 Id. at 435.

344 277 F. Supp. 519 (S.D.N.Y. 1964) discussed in Lowenfels, supra note 317, at 21. The NYSE requirements on solicitation of proxies are briefly discussed in note 202 supra and accompanying text. Exchange rules also play an extremely important role in the administration of the provisions of the act concerning delisting. See, e.g., Atlas Tack Corp. v. New York Stock Exch., 246 F.2d 311 (1st Cir. 1957); Exchange Buffet Corp. v. New York Stock Exch., 244 F.2d 507 (2d Cir. 1957).

345 339 F.2d 764 (2d Cir. 1964), discussed in Lowenfels, supra note 317, at 23-24.

346 17 C.F.R. § 240.10b-5.

change Act based on an allegation that the transaction violated NYSE rules. The court stated:

The fourth proposed allegation apparently was intended to establish an entirely new theory by claiming that the transaction violated the rules of the New York Stock Exchange. Whether or not such a violation might give rise to a cause of action against the defendants under state law, we do not think that it does so under federal law. The Exchange itself is under a federal duty to enforce its rules, . . . and this duty may be enforceable in a private suit. . . . It does not follow, however, that a suit against a listed company or its officers based on violation of an Exchange rule arises under federal law, and we see no reason for so holding.348

V. THE COLONIAL REALTY OPINION

On March 10, 1966, the Second Circuit handed down its opinion in Colonial Realty Corp. v. Bache & Co.349 The plaintiff's complaint, in the words of the court, was as follows:

Colonial Realty Corporation, a Delaware Corporation with its principal place of business in Pennsylvania, brought this action in the District Court for the Southern District of New York against Bache & Co., a limited partnership organized pursuant to the New York Partnership Law and engaged in securities brokerage in New York City. The controversy arises out of Bache's sales of securities in Colonial's margin account during the stock market dip of May and June 1962. Bache claimed it acted under authority of a clause in its standard form of margin contract in which Colonial covenanted to "maintain such margins as you may from time to time require, upon my accounts, and promptly meet all margin calls." Colonial relied on an alleged oral agreement that Bache would not require a margin in excess of the minimum requirements of the New York Stock Exchange and also claimed negligence on Bache's part. With respect to all securities sold to meet calls exceeding the Stock Exchange's minimum, Colonial sought to recover the losses it had suffered, running into millions of dollars, and some $100,000 in commissions which Bache had collected.350

This action was brought as a common law claim under state law and as an implied right under the Exchange Act. The plaintiff maintained that the right of action under the act arose because defendant's alleged conduct violated NYSE and NASD rules requiring their members to adhere to just and equitable principles of

350 Id. at 179.
trade.\textsuperscript{351} No allegation of a violation of antifraud or other rules promulgated by a governmental agency under the act was made.

The defendant moved to dismiss for failure to state a federal claim and lack of diversity. In the alternative, it sought to compel arbitration and stay the proceedings pursuant to a clause in the margin agreement. Such a pre-controversy clause probably is, because of the non-waiver language in section 29(a),\textsuperscript{352} unenforceable with respect to express and implied private rights under the Exchange Act.\textsuperscript{353}

The district court found diversity, held that the alleged violation of the self-regulatory rules stated no federal claim on which relief could be granted, and compelled arbitration pursuant to the margin agreement.\textsuperscript{354} The court found no statutory duty on members to comply with the self-regulators' rules and that the reference to "rules" in section 27,\textsuperscript{355} comprehends only agency rules.\textsuperscript{356} The

\textsuperscript{351}The applicable NASD rule requires a member to observe "high standards of commercial honor and just and equitable principles of trade." NASD Rules of Fair Practice art. III, § 1, NASD MANUAL at D-5.


\textsuperscript{355}Exchange Act § 27, 48 Stat. 902-03 (1934), as amended, 15 U.S.C. § 78aa (1964). Section 27 creates jurisdiction for actions based on violations of the Exchange Act and rules thereunder and actions to enforce any duty or liability created by the act or such rules.

court also was apprehensive that a contrary holding would, because of the breadth and reach of the standard, federalize many actions now governed by state law.\textsuperscript{357}

The Second Circuit affirmed the district court's holdings and, to a considerable extent, agreed with its reasoning.\textsuperscript{358} The Second Circuit also found that the alleged breach did not constitute a violation of the act or agency rules\textsuperscript{359} and construed the reference to "rules" in section 27, which provides jurisdiction for private suits to "enforce any liability or duty created by [the act] or the rules . . . thereunder,"\textsuperscript{360} as referring only to agency rules.\textsuperscript{361} But the Second Circuit did not consider these facts conclusive. The opinion, written by Judge Friendly, is interesting in light of his recently published views praising \textit{Erie R. R. v. Tompkins}\textsuperscript{362} while also championing the selective growth of federal common law under federal statutes and in other areas of vital or paramount federal concern.\textsuperscript{363}

The Second Circuit opinion begins with a recognition of the holding in \textit{Baird v. Franklin},\textsuperscript{364} on which the plaintiff primarily relied. Even though the court agreed that in \textit{Baird}, there was a good implied right of action against the member because the member's misconduct was a violation of the statute itself, it said that "this does not establish that implication of a private right of action against an exchange for culpable failure to enforce its rules necessarily calls for recognizing a similar right against an individual broker who is claimed to have violated them."\textsuperscript{365}

The court then gave its understanding of when and why implied private remedies are afforded under the Exchange Act:

> We start from the proposition that the judicial recognition and enforcement of a private remedy not expressly afforded by the Securities Exchange Act is predicated on the duty of the courts "to

\textsuperscript{357} See notes 396-402 \textit{infra} and accompanying text.
\textsuperscript{359} See notes 255-38 \textit{supra} and accompanying text.
\textsuperscript{361} See note 356 \textit{supra}.
\textsuperscript{362} 304 U.S. 64 (1938).
\textsuperscript{364} Baird v. Franklin, 141 F.2d 238 (2d Cir.), \textit{cert. denied}, 323 U.S. 737 (1944).
make effective the congressional purpose" represented in "the statute and the federal policy which it has adopted." ... Implication of a private right of action may be suggested by explicit statutory condemnation of certain conduct and a general grant of jurisdiction to enforce liabilities created by the statute, as in cases under §§ 10 and 14 of the Act, ... or from such considerations as the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end. ... 366

Putting stock exchange rules into context, the court noted that the question of a claim for violation of them is

a thorny problem because the effect and significance of particular rules may vary with the manner of their adoption and their relationship to provisions and purposes of the statute and SEC regulations thereunder; the difficulty lies in the scope of the unique statutory scheme of "supervised self-regulation" by exchanges and dealers' associations.367

After remarking that section 6(b)'s368 mandate "could hardly be broader," the court found something of an indication of negative congressional intent on implied rights for violation of the section 6(b) rule in the reliance in the section on the exchanges' disciplinary function to protect investors.369 This is, of course, not decisive since exchanges' disciplinary duties comprehend willful violations of the Exchange Act and Commission rules, for which the Commission can also discipline and investors can clearly assert implied rights.370

The court moved to sections 27 and 29(a), stating:

Basis for an even broader negation can arguably be found in the absence of any reference to exchange rules in the grant of federal jurisdiction over 'all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder,' Securities Exchange Act § 27, in contrast to the explicit reference to exchange rules in § 29(a) — although acceptance of this argument would not foreclose a contention that there might still be a federal claim of which district courts would have concurrent jurisdiction under 28 U.S.C. §§ 1331 or 1337. ... In O'Neill v. Maytag, 339 F.2d 764, 770 (2d Cir. 1964),

366 Ibid.
367 Ibid.
370 See, e.g., materials cited in note 244 supra.
in repudiating a belated attempt to rest federal jurisdiction on a listing agreement between a corporation and the NYSE, this court refused to give general recognition to private rights of action for alleged violations of stock exchange rules.\footnote{371}

The use of section 29(a) — with its inclusion in the non-waiver stipulation of exchange rules required by the Exchange Act, which clearly includes the section 6(b) rule — to aid in a negative conclusion on implied rights is proper in the sense that the wording of section 29(a) and of other sections proves the point about the reference to "rules" in section 27; but section 29(a) itself is, because of the non-waiver language, the best technical argument for creation of implied rights for violations of the section 6(b) rule.\footnote{372}

The analysis of section 27 also fails specifically to deal with the reference in the section to any liability or duty created by the Exchange Act itself, as opposed to rules of a government agency. If the federal courts have jurisdiction —\footnote{373} predicated upon a finding of an action arising under a federal statute or a federal statute regulating commerce — there would seem to be a liability created by the Exchange Act within the meaning of section 27.\footnote{374} The point is important in two respects. Aside from the liberal venue and service-of-process provisions in section 27, if the liability is created by the Exchange Act, federal court jurisdiction under section 27 is exclusive.

The court continued: "[W]e cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC itself."\footnote{376} In the largest sense, of course, most self-regulation for the protection of investors is a substitute for government regulation; section 15(b)(10)\footnote{378} illustrates that the unethical can be made illegal. The court, however, seemed to have something more narrow in mind, as it referred to Commission powers to alter or supplement self-regulatory rules or to issue its own superseding


\footnote{372} See notes 292-94 supra and accompanying text.

\footnote{373} 28 U.S.C. §§ 1331 or 1337 (1964).

\footnote{374} See 2 Loss, \textit{op. cit. supra} note 330, at 995.


regulations.\textsuperscript{377} Giving as an example the NYSE rule on voting of street name stock, the court said:

A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and we would not wish to say that such a rule could not provide the basis for implying a private right of action.\textsuperscript{378}

The reference to an "integral part" of Commission regulation, construed liberally, can include almost every self-regulatory rule, as many self-regulatory rules are adopted after informal Commission urging and without a formal proceeding or request to alter or supplement. The Commission may also, and sometimes without much conscious consideration, not enter a field because of existing self-regulatory requirements. Furthermore, the floor trading and specialists rules simply require exchange rules.\textsuperscript{379} Another Commission rule exempts exchange members on the basis of adequate exchange rules.\textsuperscript{380} Moreover, as discussed, the Commission can, under section 10(b),\textsuperscript{381} probably accomplish a quasi-incorporation of many self-regulatory rules by directing prior disclosure of departures from important self-regulatory rules.\textsuperscript{382}

The court then announced this test:

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation.\textsuperscript{383}

The court noted that "the case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."\textsuperscript{384} The court found the section 6(b) rule "near the opposite
pole.\textsuperscript{385} The characterization was apparently only to lack of explicitness, as the court believed that the rules, although imposing duties on members which the exchanges can enforce,

are something of a catch-all which, in addition to satisfying the letter of the statute, preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim. We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law.\textsuperscript{386}

Finally, the consequences of the view urged by the plaintiff were considered. The court found the consequences "so disruptive as to require much more impressive evidence of congressional purpose than we can discern."\textsuperscript{387} Considering arbitration first, the court said:

For example, as illustrated by this very case, the widely adopted practice of resorting to arbitration as a means of settling controversies between stockbrokers and their customers would be outlawed whenever the customer chose to rely not on breaches of contract or negligence \textit{simpliciter} but on the more sophisticated theory that the broker's acts were "inconsistent with just and equitable principles of trade," see \textit{Wilko v. Swan}, 346 U.S. 427 (1953); at least this would be so, if the rule of \textit{Wilko}, decided under the Securities Act of 1933, is applicable also under the Securities Exchange Act of 1934.\textsuperscript{388}

This, of course, oversimplifies. The Special Study did compliment the NYSE arbitration process,\textsuperscript{389} but \textit{Wilko v. Swan}\textsuperscript{390} did not "outlaw" arbitration. It held that a customer's pre-controversy agreement, contained in that case in the fine print of a margin agreement, was unenforceable by the broker against a customer who wished to try his claim — a claim of an express right under sec-

\textsuperscript{385} Ibid.
\textsuperscript{386} Ibid.
\textsuperscript{387} Ibid.
\textsuperscript{388} Id. at 182-83.
\textsuperscript{389} Special Study, pt. 4, at 559-61, 574, 577 (recommendation 5). The NASD's charter lists as one of its purposes the investigation and adjustment of grievances between the public and members and between members. Article Third (4), NASD MANUAL at C-1. Unlike the NYSE, the NASD does not have a formal arbitration procedure. A proposed code was informally submitted to the Commission in 1944, but the Commission raised several objections, and the NASD thereafter abandoned its efforts in that direction. Special Study, pt. 4, at 663 and n.448.
\textsuperscript{390} 346 U.S. 427 (1953).
tion 12(2)\textsuperscript{391} of the Securities Act — in court. The \textit{Wilko} case did not pass upon the enforceability of post-controversy agreements.\textsuperscript{392} Moreover, it is not clear that the just and equitable principles standard is to be applied in the arbitration.\textsuperscript{393}

A second disruptive effect is pointed out:

Moreover, mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits, even though the controversy was between citizens of the same state, the sum in question did not attain the jurisdictional amount required by 28 U.S.C. § 1331, and there was no indication that the case would be decided differently under state law — unless we were to make the large assumption that by requiring adoption of rules embodying this phrase Congress meant the federal courts to develop a new body of broker-customer law.

Although familiar principles require federal courts to do precisely this as to those exchange rules whose violation is held to create a federal claim, Congress scarcely contemplated judicial creation of a new body of federal broker-customer law whenever the complaint in what would otherwise be an action under state law alleged conduct inconsistent with just and equitable principles of trade.\textsuperscript{394}

Here, the court does not mention that, as discussed earlier,\textsuperscript{395} there is something of a body of federal law on just and equitable principles, supplied by Commission proceedings reviewing NASD disciplinary actions and the cases considering the \textit{Baird} case duty of exchanges. The section 15(b)(10) rules, when issued, may provide another source of development.

Finally, the court said: "moreover, if . . . [section] 27 were read to include exchange rules, the jurisdiction of the federal courts would be exclusive whenever the plaintiff alleged that violation of an exchange rule created a liability or duty created by the Security [sic] Exchange Act and the state courts would be altogether stripped of power to adjudicate claims so pleaded even between their own citizens."\textsuperscript{396} This recognizes that preemption is not at issue in im-


\textsuperscript{392} The case is discussed in 3 Loss, \textit{SECURITIES REGULATION} 1813-14 (2d ed. 1961).

\textsuperscript{393} See notes 412-14 infra and accompanying text.


\textsuperscript{395} See text accompanying notes 296-301 supra.

plied rights cases and that section 27 requires only that a plain-
tiff asserting a federal right based on the Exchange Act must
 sue in the federal court. Section 27 provides exclusive federal
court jurisdiction for federal claims under the Exchange Act;
it does not preemt. The Exchange Act expressly saves state
securities regulation and regulation of exchanges, insofar as they
are not inconsistent with the act and the Commission's rules.
Also, the act explicitly saves state common law and statutory reme-
dies, although limiting total damages, whether recovered in one or
more actions, to the “actual damages on account of the act com-
plained of.”
Section 27 says only that a claim arising under the
Exchange Act must be asserted in a federal court. If the facts con-
stitute a good cause of action under a state statute or common law
doctrine, that they may also constitute a good express or implied
private right under the act does not prevent the plaintiff from tak-
ing his choice; or, if he can find diversity or pendent jurisdiction for
the state law claims, all can be combined in one action.
This may even be the case if a state were to create a state tort based on
a violation of the Exchange Act, although a claim of a federal tort
so based or a claim under section 29(b) can be asserted only in
the federal courts.

Before offering conclusions on the most desirable handling of
implied rights under the act for violations of self-regulatory require-
ments, the effect of Commission or self-regulatory rules attempting
to negate any such rights the courts may imply will be briefly con-
sidered.

308 See §§ 6(c) and 28(a); 1 Loss, op. cit. supra note 392, at 155-58.
309 See § 28(a); note 51 supra and accompanying text.
400 These problems are discussed in 2 Loss, op. cit. supra note 392, at 973-1019; 3
(U.S. March 28, 1966), the Court adopted a liberal test concerning the power of the
federal courts to exercise pendent jurisdiction.
(1964).
402 See 2 Loss, op. cit. supra note 392, at 996-99; 3 Loss, op. cit. supra note 392,
at 2005-06. If the plaintiff can persuade a state court (1) to apply a state common
law doctrine that violations of exchange rules should be treated the same as violations
of state statutes adopted for the protection of investors (compare notes 325-29 supra
and accompanying text) or (2) to find a bilateral contractual incorporation (see notes
336-39 supra and accompanying text), the state court's jurisdiction would definitely be
unaffected by § 27. The court's statement clearly recognizes that ordinary contract and
tort actions under state law are unaffected by § 27.
VI. EFFECT OF NEGATION RULES

The conclusion stated in Part I would seem, in general, to be applicable here. Federal jurisdiction to grant relief under federal law is dependent upon the finding of a liability "created by" the Exchange Act. Thus, the self-regulators should clearly be considered without authority to promulgate binding negation rules, and the reasons given in Part I support treatment of a Commission negation rule as automatically ultra vires.

However, judicial discretion in applying the tort doctrine has, as the Colonial Realty opinion noted, often been affected by the availability or non-availability of other sufficient remedies. Therefore, the availability under the rules of a self-regulator of an effective arbitration process which gives due weight to violations of its rules could justifiably be considered sufficient in itself to preclude implication of a private right under the Exchange Act against members.

In any event, the self-regulators can provide proper tolerances — for example, that reasonable or good faith attempts to determine suitability of securities for the needs of customers will suffice. These tolerances would probably be supplied by the courts, but explicitness in the rules on this point would ensure that liability

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403 See text accompanying notes 166-79 supra.
405 See notes 413-14 infra and accompanying text. The rules of the NYSE presently require a member to arbitrate disputes arising out of its business with a nonmember, if the latter so requests. See text accompanying note 332 supra; CCH N.Y. STOCK EXCH. GUIDE §§ 1351-57, 2481-92B. The NYSE rules do not, however, specify the weight to be given in the arbitration to a member's violation of NYSE requirements.

An argument for refusing to create an implied right under the act for violations by member firms of the self-regulator's requirements when the self-regulator maintains an effective arbitration process giving appropriate weight to those violations is that the arbitration panel will probably be more familiar with the governing standard of conduct than are the courts, while the reverse is likely to be true when violations of the act or agency rules are alleged (see materials cited notes 352-53, 389-93 supra and 412-14 infra and accompanying text).

Where prospective relief is desired — say, adherence to the street-name-stock rules in a proxy contest — the lodging of a complaint with the self-regulator would seemingly most often suffice to remedy any deviation that may be present.

406 This could be done, as a practical matter, only with Commission consent. See notes 204-08 supra and accompanying text. It might be noted, however, that NASD Rules of Fair Practice art. III § 2, NASD MANUAL at D-5 requires only "reasonable grounds for believing" a recommendation is suitable. Section 3(b) may furnish the Commission with authority to define "just and equitable principles of trade," the key term in § 6(b). See also notes 152-55 supra and accompanying text. Suitability of securities for the needs of customers is discussed in note 419 infra and materials there cited.
would attach only where a proper degree of culpability is found.\textsuperscript{407} One effect of implication or possible implication of private rights is that the self-regulators may become more explicit and careful in their rules, which is both good and bad. One advantage of having businessmen participate in their own regulation is that less legally oriented regulation can be more flexible and responsive. However, optimum specificity in rules or interpretive releases is itself a desirable goal for any organization, especially one exercising governmental-type powers.\textsuperscript{408}

\section*{VII. Conclusion and A Suggested Test}

Reservations on some of the statements in the \textit{Colonial Realty} opinion should not obscure three far more important points: (1) The correct result was reached in the case before the court; (2) The court’s approach demonstrates a penetrating and sophisticated appreciation of the complexities and subtleties of the two-tier governmental and “non-governmental” structure of Commission regulation and self-regulation; and (3) The dictum that some self-regulatory requirements may form the foundation for implied rights under the Exchange Act leaves the door open for judicial statesmanship in effectuating the purposes of the act and in removing what may often be a pressure for the Commission to superimpose its rules on the self-regulators’ requirements.

The conflicting pressures and fine distinctions that permeate the question of implied rights for violations of self-regulatory requirements have been mentioned. The section 6(b) rule brings with it more, and more specific, conflicting pressures. Section 29 (a) cannot be ignored. Section 6(b) squarely requires exchanges to have this rule. Foreclosing a statutory tort type of remedy under the Exchange Act seems somewhat unfair in light of the fact that customers are often bound by exchange rules under state law, even if they do not know of them, and that incorporation clauses (one was present in the margin agreement involved in \textit{Colonial}...
Yet, in balancing the interests of investors (protected by a body of remedially construed Commission antifraud rules with a potential for growth) against the adverse effects of an across-the-board leap to a new general, and potentially quite demanding, standard of legal liability for member firms, the court's answer was the proper one. Despite the precedent that has been accumulated concerning the reach of "just and equitable principles," it is an implicit standard. In one of its footnotes, the court labeled the section 6(b) rule as a commandment "vaguely adjuring [the member] to behave himself." Although this overstates, a just-and-equitable-principles standard would introduce considerable uncertainty. Moreover, the contrary result would have increased the use of litigation, rather than arbitration, to resolve disputes between investors and broker-dealers, and the increased litigation would be directed exclusively to the federal courts by section 27.

The foregoing problems would not have been as serious if member firms could obtain binding agreements from customers to arbitrate implied rights for violations of the section 6(b) rule. Broker-dealers, which naturally desire to cultivate a good reputation, prefer, in general, to avoid litigation in public proceedings. Perhaps the court could have found an implied right and construed Wilko v. Swan as inapplicable; the defendant's brief urged this result if, contrary to its argument, an implied right were found. But at this time, only the Supreme Court can issue a binding clarification of the Wilko case allowing enforceable pre-controversy agreements authorizing members to compel arbitration of implied rights of any type. Furthermore, the Court's opinion in Wilko noted the difficulties, in general submissions of the type contemplated by margin agreement clauses, in holding arbitrators to legal concepts formulated by the courts.

Where a self-regulator's requirement (even if announced in a

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410 See notes 295-301 supra and accompanying text.
release under the section 6(b) rule) is moderately specific, the balance can easily shift. The dangers of judicial misconstruction of the self-regulatory requirement diminish. Also diminished is the potential volume of new cases for the federal courts to consider. Furthermore, the amount of new federal common law to be fashioned is decreased, because the standard will have considerable content on its face.

But two additional considerations remain — comparability and the reference in Colonial Realty to self-regulatory rules that are an integral part of SEC regulation. Many moderately specific self-regulatory requirements can be considered integral parts of SEC regulation. The potential reach and lack of certainty of an "integral part" test has been mentioned. Moreover, where the SEC has failed to exercise its authority to impose requirements on nonmember broker-dealers or unlisted companies similar to those imposed by the self-regulators, it may be unfair to subject members and listed companies to implied liabilities under the Exchange Act for violation of the self-regulators' requirements. A limitation that the self-regulatory investor-protection requirement be a direct substitute for Commission regulation would maintain comparability and would produce maximum predictability in applying an "integral part" test. That a self-regulatory requirement is a direct substitute would be demonstrated by: (1) a Commission rule expressly exempting persons from its requirements on the basis of self-regulatory requirements found adequate by the Commission, or (2) a Commission rule limited to nonmembers or unlisted companies and imposing requirements similar to those imposed by the self-regulators. This approach would have several advantages. It is easy

415 Comparability is discussed in the text accompanying notes 268-78 supra. If the NASD's just-and-equitable-principles standard is considered so inexplicit that implied rights are not to be created for its violation, but other more definite standards are to furnish a base for implied rights, the same test might be applied to rules under § 15(b) (10).

416 Thus, exchange or NASD rules supplied by Commission alteration or supplementation would not be equated with Commission rules for implied rights purposes unless one of the two tests in the text were met.

On the other hand, rules of the exchanges to which the Commission's floor trading and specialists rules refer (see notes 302-04 supra and accompanying text) would be considered direct substitutes, for the Commission in both instances is exempting from its own rules on the basis of exchange rules found adequate by it.

Moderately specific NASD requirements would be considered direct substitutes whenever there is a similar Commission rule under § 15(b) (10). Such rules would, by definition, be inapplicable to NASD members. Even though the Commission might not have power under other sections to impose requirements on NASD members similar to those imposed under § 15(b) (10) on nonmembers, the promulgation of a rule under § 15(b) (10) similar to a NASD requirement places the latter squarely in the "direct
to apply, supplies the maximum predictability, and comprehends the fewest self-regulatory requirements. It would also preserve parity of treatment and would restrict implied rights to violations of ethical concepts that demonstrably could be converted into legal requirements. This approach would focus attention on the differences between the Commission's regulation of nonmembers and unlisted companies, and the self-regulators' treatment of their members and listed companies. In turn, the Commission would be induced to exercise its powers in adopting what can profitably be borrowed from the self-regulators to apply to over-the-counter companies registered under section 12(g) and to nonmember broker-dealers.

For example, in applying this test, the street-name-stock rules of the exchanges would not be considered direct substitutes until the Commission issues similar section 14(b)417 rules applicable to broker-dealers not subject to the exchange rules. The NASD's suitability requirements would not be considered direct substitutes until the Commission adopts similar requirements under section 15(b)(10),418 which would be inapplicable to NASD members.419

The use of §15(b)(10) rules to establish the direct substitute nature of certain NASD requirements and thus to base implied rights under the act on violations of such of the latter as are moderately specific and contain substantial investor-protection purpose can be criticized by arguing that the purpose of §§15(b)(8)-(10) was to allow the Commission to substitute for the NASD and not to establish that the NASD sometimes directly substitutes for the Commission. There would be some irony in using the gap-closing sections of the 1964 amendments to effect a considerable change in the consequences of violations of certain NASD rules. However, the arguments in the preceding paragraph for use of §15(b)(10) rules in the manner there suggested are stronger than the counter-arguments. Concerning the possible effect of arbitration rules and procedures on creation of implied rights for violations of NASD requirements, see notes 389, 404-05, supra and accompanying text. The chicken-and-egg type of questions discussed in this and the preceding paragraph are related to the comparability requirement underlying §§15(b)(8)-(10) (see notes 268-78, 415, supra and accompanying text).

417 See text accompanying notes 201, 305-08, 310, 329 supra.
419 Suitability is discussed in Mundheim, supra note 254; Loss, Book Review, 18 J. LEGAL ED. 238 (1966). See also notes 406-07, 416 supra and accompanying text.

Article III §2 of the NASD's Rules of Fair Practice, NASD Manual at D-5, provides that:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommenda-
Violations of the prompt disclosure requirements of exchanges would not create implied rights under the Act unless the Commission were to impose similar requirements on unlisted companies subject to section 13.420

The suggested limited approach to implied rights would also encourage the maximum feasible Commission reliance upon the self-regulators. The self-regulators should not object, as private rights would be implied only where a nonmember or an unlisted company engaging in the same conduct would be subject to civil liability because of a violation of law. This approach would also often enable plaintiffs to frame their complaints without resorting to fraud or other violation-of-law terminology, which carries with it a possibility of a stigma for broker-dealers and companies and their managements.

Judicial extension of implied rights for violation of self-regulatory requirements in the limited manner suggested would involve a minimal extension of the principles applied in Borak. Limitation to breaches of self-regulatory requirements that could be imposed as a matter of law and that in some cases are so imposed on companies or broker-dealers outside the self-regulators' requirements would restrict federal jurisdiction to those requirements that are demonstrably important in the federal scheme of regulation.

A recent guideline, NASD Manual at G-7 to G-9, notes that the NASD's rules are clearly violated when a member recommends speculative low-priced securities to customers without knowledge of, or an attempt to obtain information concerning, the customers' other securities holdings, their financial situation, and other necessary data. 420 Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 VA. L. REV. 1271, 1295-1300 (1965), discusses the problems involved and points out that good faith judgments should be deemed compliance. See also notes 406-07 supra and accompanying text.

The listing agreement presently used by the American Stock Exchange contractually requires prompt public disclosure. CCH AMER. STOCK EXCH. GUIDE 8955-59 (Listing Form L). On the other hand, the NYSE prompt disclosure policy is, with a few exceptions, not incorporated in the listing agreement currently in use. N.Y. STOCK EXCH. CO. MANUAL A-18 to A-28. See also note 333 supra and accompanying text. The requirements of the exchanges thus may not be "rules of the exchange," but this distinction should make no difference for implied rights purposes. Cf. notes 233, 344 supra and accompanying text.

The requirements of the exchanges concerning prompt disclosure of material events go well beyond those of the Commission, which are applicable to listed companies and over-the-counter companies with a security registered under § 12 (g). The Commission also imposes certain reporting requirements under § 15 (d). For the Commission's requirements, see Form 8-K. See also Form 10-K (item 4), 17 C.F.R. § 249.310 (1966 Supp.); Rule 14a-3, 17 C.F.R. § 240.14a-3 (1966 Supp.) Rule 10b-5 has not been interpreted as requiring prompt disclosure of material events when neither the company nor its insiders are trading in the company's securities.
The limitation to moderately specific requirements would assure that the standard of conduct to be applied would arrive with considerable content. The two requirements combined would place a salutary limit on the number of new cases the federal courts would be asked to consider.

By this type of limited and careful extension of implied private rights, two congressional purposes will be served. Investor protection would be strengthened, and the accomplishment of that end through the maximum feasible reliance upon the self-regulators would be encouraged.