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An Implied Right of Action Under Section 17(a): The Supreme Court Has Said “No,” But Is Anybody Listening?

DENNIS SCHOLL* and RONALD K. PERKOWSKI**

The authors critically examine recent lower court decisions implying a private right of action under section 17(a) of the Securities Act of 1933. In light of recent Supreme Court decisions, the authors conclude that the Supreme Court has effectively precluded implied rights of action under section 17(a).

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I. INTRODUCTION

For many years section 17(a) of the Securities Act of 1933¹ was

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1. Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1976). Unless otherwise stated, all references to § 17(a) are to this statute. Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

an infrequently used federal remedy for fraud.² Section 17(a), narrower in scope than rule 10b-5,³ seemed doomed to an existence as an alternative cause of action.⁴ The Supreme Court began the resurrection of section 17(a) as a viable private cause of action in 1976 when a series of its decisions, cutting back on the availability of private actions under rule 10b-5, culminated in the case of *Ernst & Ernst v. Hochfelder*.⁵

Because of the limitations placed upon private actions brought under rule 10b-5, commentators and the courts speculated about the existence of an implied private right of action under section 17(a), and whether a showing of scienter⁶ would be a prerequisite to such an action.⁷ Advocates of this theory grounded their arguments upon the same policy considerations advanced on behalf of rule 10b-5.⁸ The principal argument made for the creation of a private right of action under section 17(a) suggests that recognition of

2. Dissatisfaction with § 17(a) was so great that Congress's failure to amend its provisions to encompass frauds by purchasers led the Securities and Exchange Commission to adopt rule 10b-5. See H. SOWARDS, *THE FEDERAL SECURITIES ACT* § 10.01[1] (1981).

3. 17 C.F.R. § 240.10b-5 (1981). Unless otherwise noted, all references to rule 10b-5 are to this SEC regulation. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. See Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978).

5. 425 U.S. 185 (1976). The Supreme Court held that negligence will not support a private right of action under § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. *Id.* at 210.

6. In *Hochfelder* the Court defined scienter as "intent to deceive, manipulate, or defraud," and imposed scienter as a requirement of recovery on a private plaintiff. *Id.* at 193.

7. See generally Hazen, *supra* note 4; Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 SEC. REG. L.J. 3 (1977); Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163 (1979); Comment, *Section 17(a) of the 1933 Securities Act: An Alternative to the Recently Restricted Rule 10b-5*, 9 RUT.-CAM. L.J. 340 (1977). For cases which recognize a cause of action since *Hochfelder*, see *infra* note 81.

8. Most authoritative commentators refute arguments in favor of a private right of action under § 17(a) based upon congressional intent. See, e.g., 3 L. LOSS, *SECURITIES REGULATION* 1784-86 (2d ed. 1961); H. SOWARDS, *supra* note 2; Horton, *Section 17(a) of the 1933 Securities Act—The Wrong Place For a Private Right*, 68 NW. U.L. REV. 44 (1973). But see Hazen, *supra* note 4, at 656-58.

an implied remedy complements the express remedies of the Securities Act of 1933, thereby promoting the policy of investor protection that underlies the federal securities laws.⁹

Recently, the federal judiciary has focused considerable attention on the issue of an implied private right of action under section 17(a). Although the lower courts have greatly expanded the traditional scope of section 17(a),¹⁰ the United States Supreme Court has severely restricted private rights of action under rule 10b-5.¹¹ The Supreme Court's recent decisions, moreover, clearly articulate minimum criteria to determine if a person who alleges injury caused by a securities fraud has a statutorily implied private remedy.¹²

The federal district and intermediate appellate courts have been extremely willing to assist investors in correcting perceived injustices, regardless of conflicting principles.¹³ With the demise of rule 10b-5 as a plaintiff's cure-all, section 17(a) shows signs of becoming "the massive antifraud weapon in a plaintiff's arsenal that section 10(b) was before the Supreme Court's restrictive decisions in the securities area."¹⁴

The federal courts' attempt to circumvent the restrictions placed upon actions under rule 10b-5 by the use of section 17(a) as a securities cure-all has resulted in bad law. This result occurs whenever the courts invade the legislative domain and superimpose their own notions of equity upon those of Congress. With few exceptions,¹⁵ the federal judiciary is systematically ignoring or mis-

9. *But see infra* notes 117-20 and accompanying text.

10. *See infra* notes 57-78 and accompanying text. This article will show that the expansion of § 17(a) by a portion of the lower federal courts violates the statutory scheme of the federal securities laws.

11. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

12. *See Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979) (no implied right of private action under § 206 of Investment Advisers Act of 1940); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (no implied right of private action under § 17(a) of 1934 Securities Exchange Act); *cf. Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n*, 453 U.S. 1 (1981) (no implied right of action under Federal Water Pollution Control Act and the Marine Protection, Research and Sanctuaries Act of 1972); *Texas Indus. v. Radcliff Materials, Inc.*, 451 U.S. 630 (1981) (no implied right of contribution under anti-trust laws); *California v. Sierra Club*, 451 U.S. 287 (1981) (implied private right denied under § 10 of Rivers and Harbor Appropriation Act of 1899); *University Research Ass'n v. Coutu*, 450 U.S. 755 (1981) (no implied private right under Davis-Bacon Act for employee's back wages); *Cannon v. University of Chicago*, 441 U.S. 677 (1979) (no implied right of action under title IX of the Education Amendments of 1972).

13. *See infra* note 81 and accompanying text.

14. Steinberg, *supra* note 7, at 185.

15. *See, e.g., Shull v. Dain, Kalman & Quail*, 561 F.2d 152, 159 (8th Cir. 1977) (no private right of action under § 17(a)), *cert. denied*, 434 U.S. 1086 (1978); *Goodweather v.*

construing the recent trend of Supreme Court decisions in the securities area.¹⁶ This unilateral investor protection program has been undertaken at the expense of another policy inherent in the statutory scheme of the federal securities law: the maintenance of an orderly securities market that allows American industry access to capital infusions at the lowest cost commensurate with adequate investor protection.¹⁷

This article focuses on the lower court decisions since *Hochfelder*, and the recent attempts to create an expansive interpretation of section 17(a) in reaction to the restrictive treatment of rule 10b-5. Moreover, the article analyzes the general theory of an implied right of private action under section 17(a) in light of the recent Supreme Court decisions in the area of implied rights. The resulting conclusion is that the comparative advantages of applying section 17(a) in private actions, rather than section 10b-5, do not justify the courts' implication of these private rights of action.

II. THE LEGACY OF *Hochfelder*

Extensive documentation exists concerning the contraction of private rights under rule 10b-5;¹⁸ therefore detailed consideration is not required here. In brief, the Supreme Court has restricted private rights of action under rule 10b-5 by deciding in rapid succession that the plaintiff must be a purchaser or seller of securi-

Thompson & McKinnon Auchincloss Kohlmeyer, Inc., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,352, at 92,187, [July-Dec.] SEC. REG. & L. REP. (BNA) No. 630, at A-7 (N.D. Ohio Nov. 16, 1981) (no private action under § 17(a)); *Hill v. Der*, 521 F. Supp. 1370, 1374 (D. Del. 1981) (no private right implied in § 17(a)); *Mendelsohn v. Capital Underwriters*, 490 F. Supp. 1069, 1079 (N.D. Cal. 1979) (open question as to existence of private action under § 17(a)); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 472 F. Supp. 402, 404 n.3 (D. Colo. 1979) (no private rights under § 17(a)); *Gunter v. Hutcheson*, 433 F. Supp. 42, 45 (N.D. Ga. 1977) (no implied private right of action under § 17(a)).

16. See *infra* notes 60-78 and accompanying text.

17. Adequate investor protection does not require the protection of investors at any cost. The intent of Congress to strike a balance in this area is clearly articulated in the Congressional Record: "This legislation is designed to protect not only the investing public but at the same time to protect honest corporate business." 77 CONG. REC. 2935 (1933) (statement of Rep. Chapman); see also *infra* note 118.

The Supreme Court has recognized the congressional intent to strike a balance in this area. See *United States v. Naftalin*, 441 U.S. 768, 775 (1979) ("[N]either this Court nor Congress has ever suggested that investor protection was the sole purpose of the Securities Act." (emphasis in original)); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

18. See, e.g., A. BROMBERG, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1981); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

ties,¹⁹ prove scienter existed in the fraudulent sale,²⁰ and show an element of deception in the sale or purchase.²¹

A. *The Rebirth of Section 17(a)*

For the purpose of analyzing section 17(a), *Hochfelder* must be regarded as the seminal case. On the strength of lower court precedents, the Supreme Court recognized a private cause of action under rule 10b-5,²² but imposed a scienter requirement.²³ The Court noted that no evidence existed of any congressional intent to validate the implication of a private remedy under the rule, but still treated the existence of such a right as "well-established."²⁴ The Court's casual recognition of the private right under rule 10b-5, together with an express reservation on the issue whether an implied right exists pursuant to section 17(a),²⁵ opened the door for the lower courts to imply a remedy under section 17(a).²⁶

The *Hochfelder* Court concentrated its examination on the application of a scienter requirement in rule 10b-5 private actions.²⁷ Initially, the Court looked to the statutory construction of section 10(b),²⁸ focusing on the rule's phrase, "manipulative or deceptive."²⁹ It found that the language evinced a strong congressional intent to prohibit only knowing or intentional misconduct.³⁰ The

19. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

20. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

21. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

22. *Hochfelder*, 425 U.S. at 196.

23. *Id.* at 214.

24. *Id.* at 196; see *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.3 (1971).

25. The Court stated:

Respondents further contend that Ernst & Ernst owed them a direct duty under § 17(a) of the 1934 Act and Rule 17a-5 to conduct a proper audit of First Securities and that they may base a private cause of action against Ernst & Ernst for violation of that duty. Respondents' cause of action, however, was premised solely on the alleged violation of § 10(b) and Rule 10b-5. During the lengthy history of this litigation they have not amended their original complaint to aver a cause of action under § 17(a) and Rule 17a-5. We therefore do not consider that a claim of liability under § 17(a) is properly before us even assuming respondents could assert such a claim independently of § 10(b).

425 U.S. at 194 n.13.

26. For citation and discussion of cases that have implied a private right of action since *Hochfelder*, see *infra* note 81 and accompanying text.

27. For the definition of scienter, see *supra* note 6.

28. 425 U.S. at 197.

29. 15 U.S.C. § 78j(b) (1976). Unless otherwise noted, all references to § 10(b) are to this statute.

30. 425 U.S. at 197.

lower federal courts have relied upon this initial focus and the absence of similar language in section 17(a) to justify holding that scienter is not required in either private suits or SEC enforcement actions under section 17(a).³¹ This lower court treatment of section 17(a) in enforcement actions occurred, however, before the Supreme Court decision in *Aaron v. SEC*.³²

A focus, however, merely on the absence of statutory language in section 17(a) is superficial and misinterprets the *Hochfelder* opinion. Writing for the *Hochfelder* Court, Justice Powell rejected the SEC argument that the federal securities laws' overall policy of investor protection mandates the prohibition of negligent, as well

31. See, e.g., *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 596 (10th Cir. 1979) (absence of words such as "manipulative or deceptive device or contrivance" negates need for scienter requirement in § 17(a) actions); *SEC v. American Realty Trust*, 586 F.2d 1001, 1006 (4th Cir. 1978) (no manipulative device language in § 17(a), therefore scienter is not an element); *SEC v. Coven*, 581 F.2d 1020, 1026 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979). The language in § 10(b) relied on so heavily by the Supreme Court in imposing a scienter requirement is not present in § 17(a). But see *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795-96 (7th Cir. 1977) (imposing scienter requirement for private action under § 17(a)(2)); *Felts v. National Account Sys. Ass'n*, 469 F. Supp. 54, 64 (N.D. Miss. 1978) (requirements for cause of action under § 17(a) are same as those under § 10(b) and rule 10b-5); *Malik v. Universal Resources Corp.*, 425 F. Supp. 350, 363 (S.D. Cal. 1976) (scienter an essential element of proof under § 17(a)).

The language of § 17(a) and rule 10b-5 are remarkably similar. They are, in fact, identical except for the language noted in the text and the "in connection with the purchase or sale of" phrase in rule 10b-5. Compare *supra* note 1 with *supra* note 3. The similarity is far from coincidental. Rule 10b-5 was, in effect, copied from § 17(a) with suitable modifications intended to expand investor protection beyond the scope of the 1933 Act. As explained by Milton Freeman, an SEC attorney who had a hand in the drafting process:

I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?"

Conference on Codification of the Federal Securities Law, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton Freeman).

32. 446 U.S. 680 (1980). For a discussion of *Aaron*, see *infra* notes 40-56 and accompanying text.

as knowing and intentional conduct. The opinion set forth a lengthy analysis of both the 1933 and the 1934 Acts, noting that the two Acts "constituted interrelated components of the federal regulatory scheme governing transactions in securities."³³ "In each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake."³⁴ The opinion examined the policy that underlies investor protection and relied on more than merely the language of section 10(b). The Court took the position that the policy of investor protection is insufficient justification for the judiciary to interfere with the statutory scheme intended by Congress.³⁵

B. *The Question of Scienter After Aaron*

Despite the position of the Supreme Court in *Hochfelder*, the courts have rarely had any qualms about interfering with a statutory scheme in order to imply a private right of action under section 17(a). Two factors motivate this practice: First, extending section 17(a) enables courts to apply it to situations in which the judicially constrained rule 10b-5 can no longer reach.³⁶ Second, and more important, actions under section 17(a) provide plaintiffs with the opportunity to avoid the scienter element now required for private actions under rule 10b-5. Both motivations emanate from the use of incorrect legal propositions in cases in which courts have imposed their own notions of equity.

Many of the recent decisions dealing with rule 10b-5³⁷ and sec-

33. 425 U.S. at 206.

34. *Id.* at 207. See *infra* note 120 for sections of the statutes containing express civil remedies.

35. A dissent by Justice Blackmun stated that the majority opinion "stultifies recovery for the victim." 425 U.S. at 216. He reluctantly conceded that the statutory scheme "once again . . . rests with Congress to rephrase and to re-enact, if investor victims, such as these, are ever to have relief under the federal securities laws." *Id.* at 218.

36. See, e.g., *United States v. Jensen*, 608 F.2d 1349 (10th Cir. 1979). In *Jensen* the Tenth Circuit held that § 17(a) applies to any transaction involving the sale of stock. The United States Supreme Court, in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), required that a plaintiff be a purchaser or seller of securities before bringing a private action under rule 10b-5. The *Jensen* court, by requiring that merely a sale be involved, extended § 17(a) to an area no longer protected by rule 10b-5.

37. See, e.g., *SEC v. Caterinicchia*, 613 F.2d 102 (5th Cir. 1980) (scienter required in SEC actions brought under rule 10b-5); *SEC v. Cenco, Inc.*, 436 F. Supp. 193 (N.D. Ill. 1977) (scienter required). See generally Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419 (1977); Note, *Scienter and Injunctive Relief Under Rule 10b-5*, 11 GA. L. REV. 879 (1977).

tion 17(a)³⁸ focus on whether it is necessary to prove scienter in an SEC enforcement action. This line of lower court cases is significant because some courts have analyzed the scienter requirement in terms that apply to both private and SEC enforcement actions brought under section 17(a).³⁹

The Supreme Court attempted to halt this expansion of section 17(a) in *Aaron v. SEC*.⁴⁰ In *Aaron* the Court affirmatively answered the question expressly reserved in *Hochfelder*, "whether scienter is a necessary element in an action for injunctive relief under . . . rule 10b-5."⁴¹ The question of a scienter requirement in section 17(a) injunctive actions brought by the SEC was also examined by the Court. Certiorari was granted on these issues to resolve numerous conflicting circuit court opinions regarding the necessity of scienter in a SEC injunctive action.⁴²

In a bifurcated analysis the *Aaron* Court held that a SEC injunctive action brought under section 17(a)(1) requires a showing of scienter, but that scienter is not required under sections 17(a)(2) or 17(a)(3).⁴³ The Court distinguished the two areas by analyzing and comparing the statutory language. No language was found to

38. *Aaron v. SEC*, 446 U.S. 680 (1980) (scienter required in SEC actions brought under rule 10b-5 and § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3)); *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979) (scienter not an element under § 17(a)(2) or § 17(a)(3)); *SEC v. American Realty Trust*, 586 F.2d 1001, 1006 (4th Cir. 1978) (scienter not required under § 17(a)(2)).

39. The significance of these cases is enhanced because the courts seem to be proceeding more cautiously than the commentators. Only one district court has implied a private right of action in a case in which the existence of scienter was determinative, holding that scienter was not an element. *In re Gap Stores Secs. Litigation*, 457 F. Supp. 1135 (N.D. Cal. 1978). The courts have typically implied a private cause of action under § 17(a) when intent to defraud is present, making it unnecessary to reach the scienter issue. *See, e.g.*, *Kirshner v. United States*, 603 F.2d 234, 241 n.5 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979). *But see Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795 (7th Cir. 1977) (reserving the question of implied private right under § 17(a) because necessary element of scienter not supported by record).

Some cases have focused upon scienter requirements solely for injunctive actions. *See, e.g.*, *Aaron v. SEC*, 446 U.S. 680 (1980); *SEC v. Asset Management Corp.*, [1979-1980 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 97,278, at 96,971 (S.D. Ind. Dec. 10, 1979); *SEC v. Century Mortgage Co.*, 470 F. Supp. 300, 311 (D. Utah 1978). *See generally Comment, Scienter and SEC Injunctive Suits*, 90 *HARV. L. REV.* 1018 (1977).

40. 446 U.S. 680 (1980).

41. 425 U.S. at 193 n.12.

42. *Compare SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978) (scienter not required in SEC enforcement action under any part of § 17(a)), *cert. denied*, 440 U.S. 950 (1979) and *Steadman v. SEC*, 603 F.2d 535 (1st Cir. 1976) (scienter not required in SEC enforcement action under rule 10b-5) with *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978) (scienter required in SEC enforcement action under rule 10b-5).

43. 446 U.S. at 697.

justify restricting subsections (2) or (3) of section 17(a) to situations involving scienter.

The Court did not review congressional policy considerations because section 17(a) is "clear in its context" and consistent with legislative history.⁴⁴ "Specifically, the language of section 17(a)(1)⁴⁵ denotes conduct."⁴⁶ By contrast, the language of sections 17(a)(2)⁴⁷ and 17(a)(3)⁴⁸ does not suggest a scienter requirement.⁴⁹ These latter sections focus on the effect of particular conduct rather than the culpability of the person responsible.⁵⁰

The Court, discussing the scienter question in the context of rule 10b-5, stated:

[W]e do not write on a clean slate. Rather, the starting point for our inquiry is *Ernst & Ernst v. Hochfelder*, a case in which the Court concluded that a private cause of action for damages will not lie under § 10(b) and Rule 10b-5 in the absence of an allegation of scienter. Although the issue presented in the present case was expressly reserved in *Hochfelder*, we nonetheless must be guided by the reasoning of that decision.⁵¹

After *Aaron* the application of a singular standard, requiring proof of scienter in both private and SEC actions under rule 10b-5, militates in favor of a similar approach for section 17(a). Thus, the scienter standard under section 17(a)(1) should be grafted on to both SEC and private actions after the *Hochfelder-Aaron* progression. If a judge takes the initial step of implying a private cause of action under section 17(a), he should adopt the *Aaron* scienter analysis for that private right.⁵²

In *Aaron* the Court again avoided comment on the existence of an implied private right under section 17(a).⁵³ The decision did,

44. *Id.* at 695 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976)).

45. *See supra* note 1.

46. 446 U.S. at 696 (footnote added).

47. *See supra* note 1.

48. *Id.*

49. 446 U.S. at 696.

50. *Id.* at 696-97.

51. *Id.* at 689-90 (citations omitted).

52. Some courts have already required a showing of scienter in a § 17(a) private action. *See, e.g., Valles Salgado v. Piedmont Capital Corp.*, 452 F. Supp. 853, 858 n.8 (D.P.R. 1978); *Little v. First Cal. Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,225, at 92,554-55 (D. Ariz. Oct. 17, 1977); *see also Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795 (7th Cir. 1977) (scienter "unquestionably required" for actions based on § 17(a)(1) and (3)).

53. 446 U.S. at 691 n.9. The Supreme Court has declined review of the issue in numerous earlier opinions. *See International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.13 (1976); *Blue Chip Stamps v.*

however, reiterate the Court's commitment to strict statutory construction when reviewing federal securities law. Thus, it appears that the Court will adhere to this construction even when it "drives a wedge between section 10(b) and section 17(a)," as Justice Blackmun noted in his dissent in *Aaron*.⁵⁴ Such treatment yields a narrow scope of review when implied rights of action are not expressly stated in either the statute or its legislative history. Thus, the implication of a private right under section 17(a) conflicts with *Hochfelder*, its progeny, and the statutory scheme as a whole.⁵⁵ Despite the problems inherent in this interpretation, and the recent posture taken by the Supreme Court, some lower courts continue to treat the Court's handling of section 17(a) with disdain.⁵⁶

III. BEYOND RULE 10b-5—THE FEDERAL JUDICIARY'S EXPANSION OF SECTION 17(a)

Aside from the scienter requirement, courts have given section 17(a) an expansive interpretation since *Hochfelder*. Admittedly, section 17(a) is not coterminous with rule 10b-5. For example, an offer to sell is sufficient to trigger application of section 17(a),⁵⁷ and actions against purchasers of securities are not contemplated by the statute.⁵⁸ In addition, application of section 17(a) had traditionally required a closer relationship between the fraudulent act and the securities transaction than rule 10b-5.⁵⁹ The necessity for

Manor Drug Stores, 421 U.S. 723, 733-34 n.6 (1975).

54. 446 U.S. at 715 (Blackmun, J., dissenting in part). In a concurrence, Chief Justice Burger strongly rebutted this statement. Lower courts should review the Chief Justice's statement before creating a judicial remedy under the securities laws:

[It] is not this Court that 'drives a wedge;' Congress has done that. The Court's holding is compelled in large measure by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and gives effect to congressional intent as manifested in the language of the statutes and in their histories. If, as intimated, the result is 'bad' public policy, that is the concern of Congress where changes can be made.

Id. at 702-03 (Burger, C.J., concurring).

55. See *infra* notes 117-23 and accompanying text.

56. See, e.g., *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1233 n.6 (S.D.N.Y. 1981).

57. See, e.g., *SEC v. Spence & Green Chem. Co.*, 612 F.2d 896 (5th Cir. 1980), cert. denied, 449 U.S. 1082 (1981). "While section 17(a) pertains to offers as well as sales, . . . rule 10b-5 appl[ies] only to acts occurring 'in connection with the purchase or sale' of securities." *Id.* at 903 (quoting rule 10b-5(c)).

58. See *supra* note 2.

59. *SEC v. Penn Cent. Co.*, 450 F. Supp. 908 (E.D. Pa. 1978): "We must emphasize, however, that the plaintiff will have to demonstrate at trial a more direct involvement in the offer or sale of securities to make out a § 17(a) violation than is necessary to establish a violation of § 10(b) and Rule 10b-5." *Id.* at 916. Rule 10b-5 is in fact an expansion of §

this closer relationship, however, has recently been relaxed as a result of the federal judiciary's expansion of section 17(a). This expansive reading of section 17(a) allows courts to apply the statute to frauds considered only incidental to the sale of securities.

In *United States v. Jensen*,⁶⁰ the United States Court of Appeals for the Tenth Circuit held that section 17(a) will apply to any transaction in which fraud is present, if the transaction contains the sale of stock as an element.⁶¹ Furthermore, in an attempt to encompass the most attenuated circumstances, the fraud need not relate specifically to the sale of the securities, but only to the transaction which contained the sale.⁶²

Another example of the expansive interpretation given section 17(a) is presented in *Kirshner v. United States*.⁶³ In *Kirshner* the beneficiary of a pension fund sued the United States, federal officials, and the trustees of the fund who, inter alia, bought and sold New York City municipal bonds.⁶⁴ As a result of misinformation supplied by the fund, the IRS had issued tax rulings and Congress had enacted legislation⁶⁵ that permitted the trustees to purchase a large amount of securities issued by the City of New York.⁶⁶ The fund's purchases of the securities were sufficient to allow a claim by the beneficiary under section 17(a).⁶⁷ A dissent by Judge Moore set forth a cryptic message that a majority of the federal judiciary has to date ignored:

There has been a tendency over recent years to rely upon various sections of the Securities Exchange laws to create causes of action by the recital of section numbers such as § 10(b), Rule 10b-5 and § 17, as if the mere recital had a talismanic effect and would bring some kind of a triable action into being.⁶⁸

17(a), and therefore, it would appear that an action under § 17(a) requires a closer tie with the securities transaction than one brought under rule 10b-5. See *supra* note 31.

60. 608 F.2d 1349 (10th Cir. 1979).

61. *Id.* at 1355. "If the sale of stock is an element, the transaction is within section 17(a), and if fraud is involved in the transaction, there is fraud in the sale of securities." *Id.*

62. *Id.* at 1354; see *United States v. Brown*, 555 F.2d 336 (2d Cir. 1976). "We see no purpose in construing the statute [§ 17(a)] so narrowly and we have not in the past." *Id.* at 339.

63. 603 F.2d 234 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979).

64. *Id.* at 236-39.

65. Act of Aug. 20, 1975, Pub. L. No. 94-236, 90 Stat. 238 (application of certain provisions of Internal Revenue Code of 1954 to specified transactions by New York public employee retirement systems).

66. 603 F.2d at 237-38.

67. *Id.* at 241.

68. *Id.* at 242 (Moore, J., dissenting).

The Supreme Court of the United States advanced the lower court expansion of section 17(a) when it decided *United States v. Naftalin*.⁶⁹ In *Naftalin* the Court upheld the criminal conviction, under section 17(a)(1), of a professional investor who made short sales of stock while falsely representing to the brokers that he owned the stock he directed them to sell.⁷⁰ The Supreme Court held that the language of section 17(a)(1) was broad enough to encompass frauds committed against brokers who had not purchased the securities.⁷¹ The Court's expansive interpretation in *Naftalin* suggests that section 17(a), in the context of a criminal action, is at least as broad as rule 10b-5 when the sale of securities is involved. Such an interpretation may effectively preclude application of the purchaser-seller requirement of *Blue Chip Stamps v. Manor Drug Stores*⁷² to actions brought under section 17(a).⁷³ Subsequently, the Supreme Court, in *Rubin v. United States*,⁷⁴ ruled that the mere pledge of securities as collateral constituted a "sale" within the meaning of section 17(a).⁷⁵

When reviewed together, these cases give a new but untested vitality to section 17(a), independent of rule 10b-5. The existence of an implied right of private action under section 17(a) is clearly no longer the innocuous issue glossed over by Judge Friendly in *SEC v. Texas Gulf Sulphur Co.*⁷⁶ Implication of a private right of action under section 17(a) will greatly impact upon the national securities markets. Because the expansive interpretation of this section primarily is a reaction to the recent limitations placed

69. 441 U.S. 768, 773 n.4 (1979) (the language of § 17(a), "in" the offer or sale, does not necessarily connote a narrower range of activities than the phrase, "in connection with," of § 10(b)). For an excellent review of *Naftalin* and its relationship to an expanded reading of § 17(a), see Steinberg, *supra* note 7.

70. 441 U.S. 768 (1979).

71. 441 U.S. at 773-74. In the lower court decision in *Naftalin*, the United States Court of Appeals for the Eighth Circuit once again ruled against an expansion of § 17(a), this time in a criminal context. 579 F.2d 444 (8th Cir. 1978), *rev'd*, 441 U.S. 768 (1979); see *Shull v. Dain, Kalman & Quail*, 561 F.2d 152, 159 (8th Cir. 1977) (rejecting implied action in a civil case under § 17(a)), *cert. denied*, 434 U.S. 1086 (1978).

72. 421 U.S. 723 (1975) (decided under rule 10b-5).

73. See *Reid v. Madison*, 438 F. Supp. 332, 334-35 (E.D. Va. 1977).

74. 449 U.S. 424 (1981); see *United States v. Gentile*, 530 F.2d 461, 466-67 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

75. 449 U.S. at 431.

76. 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969):

Once it had been established, however, that an aggrieved buyer has a private action under § 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under § 17—with the important proviso that fraud, as distinct from mere negligence, must be alleged.

upon rule 10b-5 actions, it is important to review the cases implying a private cause of action solely under section 17(a) after *Hochfelder*.⁷⁷ These recent lower court decisions must be weighed and evaluated against the body of law developed by the Supreme Court.⁷⁸

IV. RIGHTING WRONGS: THE FEDERAL JUDICIARY'S CREATION OF AN IMPLIED RIGHT

Although the existence of an implied right of action under section 17(a) was first recognized over thirty years ago,⁷⁹ the long shadow of rule 10b-5 made this recognition relatively meaningless in the practical context of investor actions.⁸⁰ The acknowledgment of an implied private remedy under section 17(a) became important only after *Hochfelder* restricted application of rule 10b-5. Following *Hochfelder*, plaintiffs began to aggressively pursue an expansion of section 17(a)'s scope.

Since *Hochfelder*, virtually all of the United States courts of appeals that have considered the question have expressly or impliedly recognized a private cause of action under section 17(a).⁸¹

77. Before *Hochfelder*, judges were less careful in implying a cause of action under § 17(a) because of the ease of obtaining a rule 10b-5 implied action. After *Hochfelder* imposed a scienter limitation on a private action under rule 10b-5, however, § 17(a) ceased to be a secondary "coat-tail" issue. Thus, § 17(a) cases brought after *Hochfelder* must be reviewed independently of those cases decided before *Hochfelder* because of the primary importance attached to a § 17(a) claim in the subsequent cases.

78. See *supra* note 18.

79. *Osborne v. Mallory*, 86 F. Supp. 869, 879 (S.D.N.Y. 1949). Two years later, in *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 787 n.2 (2d Cir. 1951), the United States Court of Appeals for the Second Circuit noted that a private action under § 17(a) might proceed free of the restrictions imposed by § 11 of the 1933 Securities Act.

Professor Loss stated that the existence of a private right to damages under § 17(a) seemed to be "taken for granted." 6 L. LOSS, SECURITIES REGULATION 3913 (2d ed. Supp. 1969).

80. See *supra* note 76.

81. See *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1245 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979); accord *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040 n.2 (7th Cir. 1979) (finding a cause of action under § 17(a)); *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978) (section 17(a) supports a private claim for damages), *cert. denied*, 442 U.S. 909 (1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 698 n.30 (1st Cir. 1978) (implying that a private right may be pursued under § 17(a)); *Frischling v. Priest Oil & Gas Corp.*, 524 F. Supp. 1107 (N.D. Ill. 1981) (finding a private right of action under § 17(a)); see also *Forrestal Village, Inc. v. Graham*, 551 F.2d 411 (D.C. Cir. 1977) (dismissing private cause under § 17(a), but on statute of limitations grounds); *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976) (allowing claims under § 17(a) to proceed without being barred by statute of limitations), *cert. denied*, 429 U.S. 1074 (1977). *But see Goodweather v. Thompson & McKinnon Auchincloss Kohlmeyer, Inc.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,352, at 92,187, [July-Dec.] SEC. REG. & L. REP. (BNA) No. 630, at

Only the Eighth Circuit has rejected the notion of a private remedy under the section.⁸²

The primary analytical justification for implying a private action under section 17(a) has been the similarity of language between that section and rule 10b-5.⁸³ Because a private right of action is recognized under rule 10b-5, courts have freely implied a similar private action under section 17(a).⁸⁴ This analogous reasoning led some courts to place restrictions on section 17(a) actions similar to those imposed on actions under rule 10b-5 and section

A-7 (N.D. Ohio Nov. 16, 1981) (no private right of action under § 17(a)). See generally Hazen, *supra* note 4.

In the Second Circuit, a three-judge panel recently tried to reserve the question whether a private right of action exists under § 17(a), but was forced to amend its opinion in light of the *Kirshner* holding. *Wigand v. Flo-tek, Inc.*, 609 F.2d 1028, 1038 (2d Cir. 1980). And at least one court has avoided deciding whether a private right of action exists under § 17(a) by relying instead on § 10(b). In *Sterling Recreation Org. Co. v. Segal*, [Jan.-June] SEC. REG. & L. REP. (BNA) No. 19, at 843 (D. Colo. Apr. 27, 1982), a United States district court held that the existence of a private right of action under § 17(a) is "only relevant if there is conduct that has damaged a plaintiff that is prohibited by § 17(a) and not by regulations promulgated under § 10(b)."

Two pre-*Hochfelder* decisions continue to be good law. See *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975) (recognizing an implied cause of action under § 17(a)), followed in *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith*, 464 F. Supp. 528, 537 (D. Md. 1978); *Schultz v. Cally*, 528 F.2d 470, 475 n.11 (3d Cir. 1975) (reserving the question). But see *Hill v. Der*, 521 F. Supp. 1370, 1374 (D.C. Del. 1981) (no private right of action implied in § 17(a)).

The Fifth Circuit has avoided a determination of the issue since *Hochfelder*. See *Pharo v. Smith*, 621 F.2d 656, 673-74 (5th Cir. 1980), where the court failed to reach the issue, but noted that if there was an action under § 17(a), the same procedural restrictions applicable to § 12 of the 1933 Act and § 10(b) of the 1934 Act would apply. The District of Columbia Circuit, noting the conflict in the other circuits, has also left the issue open. See *Wachovia Bank & Trust Co. v. National Student Mktg. Corp.*, 650 F.2d 342, 350 n.19 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981).

Before *Hochfelder*, the Fifth, Sixth, and Ninth Circuits implicitly allowed a § 17(a) private claim for damages. None of the courts, however, elaborated on its decision. See *Kellman v. ICS, Inc.*, 447 F.2d 1305 (6th Cir. 1971); *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152 (5th Cir. 1969); *Harris v. Palm Springs Alpine Estates*, 329 F.2d 909 (9th Cir. 1964). Noting that the Supreme Court has not decided the issue, the Ninth Circuit recently decided in favor of the existence of a private right of action under § 17(a). See *Stephenson v. Calpine Confers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981) (relying on the decision of the Second Circuit in *Kirshner*).

At least one United States district court has remained adamantly opposed to the implication of a private right. *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 472 F. Supp. 402, 404 n.3 (D. Colo. 1979) (stating that no federal district court in Colorado has held that there is a private action under § 17(a)).

82. *Shull v. Dain, Kalman & Quail*, 561 F.2d 152, 159 (8th Cir. 1977), cert. denied, 434 U.S. 1086 (1978); see *supra* note 71.

83. *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1094 (E.D. Pa. 1972); *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949).

84. *Id.* at 1095; see also *supra* note 76.

12(a). At times, courts required scienter in a section 17(a) private action.⁸⁵ Alternatively, some courts subjected private actions under section 17(a) to the same procedural restrictions present in section 12(a) of the Securities Act of 1933.⁸⁶ This method aids in minimizing the disruption of the statutory scheme of the 1933 Act.⁸⁷

These approaches appear, however, to rest upon inconsistent logic. The courts find rule 10b-5 and section 12(a)(2) important enough to provide relevant procedural limitations when they imply an action under section 17(a). Nevertheless, they tend to ignore the substantive differences between the provisions when they create a section 17(a) implied right. But if section 17(a) is not substantively different from rule 10b-5 and section 12(a)(2), the courts' work construing section 17(a) has been pointless. It appears however that just the opposite is true: the provisions differ significantly.⁸⁸

When the courts recognize these differences, they will realize that implying a private right under section 17(a) affects the pattern and depth of enforcement of the securities laws. This implied remedy causes increased securities costs due to excess litigation. Moreover, attempts to prevent private allegations of fraud under section 17(a) require a more carefully structured form of offer of sale. It is not enough to say that the impact of these substantive differences is minimized by imposing limitations drawn from other provisions, since the most important statutory restriction, standing

85. See, e.g., *Wachovia Bank & Trust Co. v. National Student Mktg. Corp.*, 461 F. Supp. 999, 1006 (D.D.C. 1978), *rev'd on other grounds*, 650 F.2d 342 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Valles Salgado v. Piedmont Capital Corp.*, 452 F. Supp. 853, 858 n.8 (D.P.R. 1978); *Little v. First Cal. Co.*, [1977-1978 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶ 96,225, at 92,555 (D. Ariz. Oct. 17, 1977).

86. 15 U.S.C. § 77l (1976). Section 12(a) provides:

Any person who—

. . . .

(2) offers or sells a security . . . which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him

87. See *In re Gap Stores Secs. Litigation*, 457 F. Supp. 1135, 1142 (N.D. Cal. 1978) (citing *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089 (E.D. Pa. 1972)). Imposing a procedural restriction on a § 12 civil remedy is arguably a part of the legislative intent of the 1933 Act. Analogizing an expansion of the 1934 Act's rule 10b-5 disrupts the statutory scheme intended by Congress for the 1933 Act.

88. There has been a significant increase in the scope of § 17(a) during the past several years due to the judicial gloss applied to the statute.

to sue, will be removed.⁸⁹ This will place section 17(a) in the all too familiar expanded posture of rule 10b-5 before the Supreme Court's decisions in *Hochfelder* and subsequent cases.

If section 17(a) is to be given this expanded reading, the courts must find an independent justification for the implication of a private remedy other than general equity concepts of investor protection rejected by the Supreme Court in limiting the scope of rule 10b-5. One attempt to provide this independent justification is the theory that rule 10b-5 private actions are useful only as an analogy and are not dispositive of the issue. The theory then concludes that the wording of section 17(a) is broad enough to support the implication of its own private right of action without having to refer to other statutory provisions.⁹⁰

The potential ramifications of this approach are disturbing. First, the analysis looks only at the statutory language, ignoring considerations of congressional intent.⁹¹ Moreover, by concluding that a private action under section 17(a) has an independent basis, the analytical support for imposing restrictions garnered from other statutory provisions is removed.⁹²

Another justification offered by the courts is that implying private rights under section 17(a) assists the Securities and Exchange Commission in enforcing the section.⁹³ The proponents of this theory also argue that the cases decided under rule 10b-5 provide precedent for the judiciary to impose its own notions of equity upon the law.⁹⁴ The argument is based upon the concept of investor protection. In an effort to achieve this goal of investor protection, the courts appear willing to sacrifice other policies also inherent in the securities laws, such as the maintenance and stability of a national market.⁹⁵ This approach also indicates the willingness of the courts to reject traditional methods of statutory construction.⁹⁶

89. See *supra* note 72 and accompanying text. The Court in *Blue Chip* held that only purchasers and sellers of securities have standing under rule 10b-5.

90. *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1245 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979).

91. Recent Supreme Court cases have made it clear that congressional intent is the relevant focus of analysis in these inquiries. See cases cited *supra* notes 11-12.

92. Indeed, the United States Court of Appeals for the Seventh Circuit used this approach in *Daniel* and implied that an action brought under § 17(a), unaccompanied by a rule 10b-5 claim, need not prove scienter as an element. 561 F.2d at 1246 n.47.

93. See, e.g., *Demoe v. Dean Witter & Co.*, 476 F. Supp. 275, 281 (D. Alaska 1979) (implying a cause of action under § 17(a)(3)).

94. *Id.*

95. See *infra* note 118.

96. See generally *Hazen*, *supra* note 4, at 654 n.70.

Implying a private right of action under section 17(a) would doubtlessly provide a major benefit to the SEC enforcement program. The deterrent effect alone would be substantial. Nevertheless, these policy arguments were offered by the SEC against the imposition of a scienter standard in rule 10b-5 actions, but were rejected by the Supreme Court in *Hochfelder*.⁹⁷

In the aftermath of the Supreme Court's restriction of rule 10b-5, the lower federal courts are demonstrating a disturbing willingness to selectively ignore Supreme Court precedent and reject legislative intent in favor of their own notions of an extended form of investor protection. Yet notions of equity must arise from and be limited by the statute and its accompanying legislative history, not the subjective perceptions of the judiciary. Legislative, not judicial intent must provide the grounds for determining whether to imply a private right of action under a statute. This proposition was clearly reinforced by two recent Supreme Court decisions.

V. THE MODIFIED *Cort* ANALYSIS

The Supreme Court has not expressly determined whether an implied private right of action exists under section 17(a).⁹⁸ If the question comes before the Court, recent decisions leave little doubt that a majority of the Justices⁹⁹ will override the lower courts' expansive reading of section 17(a), and thereby maintain the integrity of the securities laws as enacted by Congress.¹⁰⁰

97. 425 U.S. at 214.

98. See *supra* note 53. The other "§ 17(a)" case to be noted is *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979). In *Redington* the Court held that there was no implied private right of action under § 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(a) (1976). 442 U.S. at 569. The section is not comparable to § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1976).

99. Only Justice Brennan has consistently rejected a narrow reading of the federal securities laws, joining or drafting the dissent in *Aaron v. SEC*, 446 U.S. 680 (1980); *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). Justice Blackmun has followed a similar trend with dissents in *Blue Chip*, *Hochfelder*, *Santa Fe* (dissenting in part), and *Aaron*. The remaining Justices have shown surprising agreement in the narrow construction and evaluation of the federal securities laws with respect to implied private rights. See *infra* note 108.

100. Cf. *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979) (no private right under § 206 of the Investment Advisers Act of 1940); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (no private right under § 17(a) of the 1934 Securities Exchange Act); see also *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979) (no private right under the Freedom of Information or the Trade Secrets Acts). But cf. *Cannon v. University of Chicago*, 441 U.S. 677 (1979) (implying a private right of action under title IX of the Education Amendments of 1972); *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982) (lesser

The seminal case in interpreting an implied private statutory remedy is *Cort v. Ash*.¹⁰¹ During the 1978 Term, the Supreme Court considered the question of implied private rights of action at least five times,¹⁰² and in each case applied the detailed analysis developed in *Cort*.

Cort sets forth four specific factors to determine if a private remedy is implicit in a statute that does not expressly provide for one.¹⁰³ First, the private plaintiff must be "one of the class for whose *especial* benefit the statute was enacted."¹⁰⁴ If the statute fails to create a federal right in favor of the plaintiff, then no further inquiry is needed: the plaintiff lacks standing and the private right of action is precluded. Second, the *Cort* analysis looks to the legislative intent, using available sources such as committee reports.¹⁰⁵ Third, the court must decide whether the implication of a private remedy is "consistent with the underlying purposes of the legislative scheme."¹⁰⁶ These related factors allow an additional review of the legislative intent that underlies the structure and development of the statute. Finally, *Cort* requires a basic application of the principles of federalism to ensure that the judicial implication of a private remedy does not usurp "an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on Federal law."¹⁰⁷

showing required to imply right of action under Commodity Exchange Act when implied right antedated statute).

The Supreme Court last acknowledged the existence of a private right of action in the securities field in *Hochfelder*. There, the Court bowed to 25 years of judicial precedent. 425 U.S. at 196. Yet an implied private right of action under rule 10b-5 would probably not be upheld if the issue were presented to the Court today. *But cf.* *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979) (refusing to imply a private right of action under a section of another act that is similar in wording to rule 10b-5).

The ambush awaiting private plaintiffs under § 17(a) at the Supreme Court level is evidenced by the Court's conservative trend in deciding recent securities cases. *See, e.g.*, *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (narrowly construing the definition of a security); cases cited *supra* notes 19-21. This clear manifestation by the Supreme Court of its position renders the lower federal court decisions that imply a private right of action under § 17(a) all the more questionable.

101. 422 U.S. 66 (1975).

102. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 562 n.1 (1979).

103. 422 U.S. at 78.

104. *Id.* (quoting *Texas & Pacific Ry. v. Rigsby*, 241 U.S. 33, 39 (1916) (emphasis added by the Court)).

105. 422 U.S. at 78.

106. *Id.*

107. *Id.*

A. Redington

The *Cort* test has undergone substantial modification since it was first formulated by the Supreme Court, especially in the area of securities law.¹⁰⁸ *Touche Ross & Co. v. Redington*¹⁰⁹ presents one such modification. The Court in *Redington* acknowledged that the factors set forth in *Cort* formed the traditional judicial criteria used to determine whether a private remedy is implicit in a statute that does not expressly provide for one.¹¹⁰ These factors were not, however, weighed equally. The "central inquiry" became whether Congress actually intended to create a private right, thereby making the right more difficult to obtain.¹¹¹

The *Redington* decision revised the *Cort* analysis by imposing a two-part threshold inquiry. First, the statute must either grant an express private right to an identifiable class or imply one by proscribing some conduct as unlawful. If a plaintiff fails to meet this first factor, he lacks the minimum constitutional criteria for standing and his asserted implied right will be rejected. If this ele-

108. Characterizing the current Supreme Court as "conservative" in the securities law field is probably accurate, but the conservative results seem to rest more on the desire to interpret statutes narrowly and avoid proliferation of litigation than on the desire to favor defendants. Nevertheless, it is possible to characterize the attitudes of Justices by keeping track of their decisions. For what it is worth, the outcome of cases can be characterized as pro-plaintiff or pro-SEC and as pro-defendant or anti-SEC. Using this approach, the eight sitting Justices who have decided securities law cases can be ranked on rough percentages. Asking the question in terms of whether each Justice has decided cases in favor of defendants or against the SEC, the pro-defendant or anti-SEC rankings are as follows:

	Number of cases	Pro-Defendant/ Anti-SEC	%
1. Powell	36	27	75
2. Rehnquist	35	26	74
3. Burger	41	28	68
4. Blackmun	39	20	51
5. Stevens	19	9	47
6. Marshall	41	18	48
7. White	49	18	44
8. Brennan	53	14	26

The above figures are slightly skewed because of the relatively high number of private rights cases. Private rights cases, however, offer some insights into judicial philosophy. Remarks by David S. Ruder, Dean and Professor of Law, Northwestern University School of Law, on *Supreme Court Influence on Corporate Securities Litigation*, at the 20th Annual Corporate Counsel Institute, Chicago, Illinois, October 15, 1981 (available in the University of Miami Law School library).

109. 442 U.S. 560 (1979).

110. *Id.* at 575-76. As the Court stated, these criteria were "the language and focus of the statute, its legislative history, and its purpose." *Id.*

111. *Id.*

ment is satisfied, the court will inquire into the second threshold factor: the plaintiff must demonstrate that the implied private action is based solely on federal law. A plaintiff is required to show this exclusively federal basis because of the structure of federalism implicit in the Constitution. The *Redington* Court imposed these threshold factors because the Constitution mandates these limitations upon the judiciary's creation of a statutorily implied right of action. Once a plaintiff demonstrates that he has met these threshold criteria, he must show that all four *Cort* factors are satisfied before a court may properly imply a private remedy.¹¹²

At this point, it would be instructive to apply the *Cort-Redington* analysis to section 17(a). Section 17(a) clearly makes certain conduct unlawful.¹¹³ Thus, the first part of the modified *Cort-Redington* threshold test is met. And because enforcement of securities laws has long been a bifurcated task requiring participation by both federal and state governments, the Constitution's federal structure does not prohibit the existence of an implied right of action.

The remaining *Cort* factors pose a more serious, if not insurmountable barrier to a private right of action under section 17(a).¹¹⁴ Both the legislative history and the statutory scheme show that Congress did not intend to create a private right of action under section 17(a).¹¹⁵ Under the modified *Cort* test, the principal factor in determining whether a statute creates an implied right is the intent of Congress.¹¹⁶ The courts, at the time of this writing, have failed to reconcile legislative intent with the use of section 17(a) as a basis for a private cause of action.

112. Compare *Redington*, 442 U.S. at 575-76 with *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 23-25 (1979).

113. See *supra* note 1.

114. But see Steinberg, *supra* note 7, for an analysis of the *Cort* test applied to § 17(a) that yielded a contrary result. Steinberg reviews the factors applied in recent Supreme Court cases and concludes that it is possible for defrauded offerees and purchasers of securities to pursue private damage remedies under § 17(a) of the Securities Act of 1933. *Id.* at 163. This article was written before the recent Supreme Court decision, *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979), which denied an implied private right of action under § 206 of the Investment Advisers Act of 1940—a provision substantially similar to § 17(a). One court has already rejected the argument offered by Steinberg as inappropriate in a civil action. *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 650 n.28 (N.D. Cal. 1980).

115. See notes 118-23 and accompanying text *infra*.

116. See *Touche Ross & Co. v. Redington*, 442 U.S. at 575-76; *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. at 23-25. But cf. Note, *Section 17(a) of the Securities Act of 1933: Implication of a Private Right of Action*, 29 U.C.L.A. L. REV. 244 (1981) (lack of legislative expression of intent regarding § 17(a) meets *Cort* test).

B. *Legislative Intent*

As noted in *Hochfelder*, the legislative scheme of the securities laws works as an integrated whole.¹¹⁷ Examined in this context, the securities laws are designed to facilitate several objectives. Investor protection was not only an end in itself; it was also a means of maintaining a stable and ongoing securities market.¹¹⁸ Congress intended to create a balanced scheme that would protect investors and encourage investment without imposing unnecessary costs on those seeking capital.¹¹⁹ Within this statutory scheme Congress provided for civil remedies applicable to certain sections.¹²⁰ Section 17(a) is not one of these. The failure of Congress to provide a civil remedy for section 17(a) cannot be dismissed as an oversight. As a result, courts should assume that the legislature knew how to provide for private actions in the statute and chose not to do so in this section of the 1933 Act.

When express remedies *are* granted in the securities laws, they are subject to procedural limitations specifically devised to implement congressional intent regarding the workings of that particular section within the overall statutory scheme. For example, section 12(2) allows recovery for certain negligent behavior, but requires privity between the purchaser and the seller, and only provides for rescission as a remedy.¹²¹ This careful delineation of constraints exemplifies the absence of any congressional intent to create a sec-

117. 425 U.S. at 206.

118. See S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933):

The purpose of this bill is to protect the investing public and honest business

The aim is . . . to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

As this quotation makes clear, Congress intended securities regulation to benefit society as a whole by maintaining markets. At the time of the legislation, investors had been driven out of the market by the 1929 stock market crash and their protection was a means to a larger end. Taken to its logical extension, this argument suggests that in the current market, even less protection is needed because sophisticated institutional investors, economically capable of taking care of themselves, dominate the market.

119. See *supra* note 17.

120. There are seven express civil remedies provided by the 1933 and 1934 securities acts. There are three in the Securities Act of 1933: §§ 11, 12, and 15 (codified at 15 U.S.C. §§ 77k, 77l, 77o (1976)). There are four express civil remedies in the Securities Exchange Act of 1934: §§ 9, 16, 18, and 20 (codified at 15 U.S.C. §§ 78i, 78p, 78r, 78t (1976)).

121. 15 U.S.C. § 77l(2) (1976).

tion providing civil remedies without any limitations on its application. Section 12(2) and section 17(a) are essentially counterparts in the 1933 Act.¹²² Consequently, an analysis of section 12(2) is especially relevant to the question of an implied right under section 17(a). It would be contrary to congressional intent for the courts to allow a private right of action that would circumvent the statutory constraints reflected by the limitations of section 12(2).¹²³

Despite this legislative history, the lower courts have allowed a private right of action under section 17(a), analogizing it to the implied private right of action under rule 10b-5.¹²⁴ This focus ignores the *Redington* Court's insistence, recently reaffirmed in *Curran*, that the central inquiry be on the statutory language and congressional intent.¹²⁵ The *Redington* approach prevents the courts from indiscriminately applying to section 17(a) their own construction of a similarly worded provision that is outside the statute.

These recent Supreme Court decisions indicate that the Court would deny that a private right of action is implicit within section 17(a) simply because it is similar to rule 10b-5. This warning to the lower courts is especially manifest in the Supreme Court's recent decision that denied an implied right of action under a statute

122. Both § 12(2) and § 17(a) are part of the 1933 Act. Section 12(2) establishes civil remedies for fraud while § 17(a) creates criminal sanctions for fraud.

123. An excellent summary of the sources construing congressional intent appeared in *Texas Gulf Sulphur Co.*:

[T]here is unanimity among the commentators, including some who were in a peculiarly good position to know, that § 17(a)(2) of the 1933 Act—indeed the whole of § 17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§ 11 and 12. See Landis, *Liability Sections of Securities Act*, 18 Am. Acct. 330, 331 (1933); Douglas and Bates, *Federal Securities Act of 1933*, 43 Yale L.J. 171, 181-82 (1933); 3 Loss, *Securities Regulation 1785-86* (1961). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§ 11 and 12 and stated that "[t]o impose a greater responsibility [than that provided by §§ 11 and 12] *** would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public." H. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933).

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring) (emphasis added), cert. denied, 394 U.S. 976 (1969); see also Horton, *supra* note 8.

124. See, e.g., *Demoe v. Dean Witter & Co.*, 476 F. Supp. 275, 281 (D. Alaska 1979).

125. Despite the identical nature of the language, analysis under § 17(a) and rule 10b-5 differs. The language similarity is due to historical accident rather than congressional intent. See *supra* note 31. Furthermore, different statutes are involved. Rule 10b-5 looks to § 10(b) of the 1934 Act while § 17(a) is part of the 1933 Act.

The Court in *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982), held that in addition to legislative intent, courts should review the state of the law when the legislation was enacted. *Id.* at 1841.

strikingly similar to both rule 10b-5 and section 17(a).

C. Transamerica: *The Final Warning?*

In *Transamerica Mortgage Advisors v. Lewis*,¹²⁶ the Court refused to imply a private right of action under section 206 of the Investment Advisers Act of 1940,¹²⁷ despite the fact that the language of subsections (1) and (2) is substantially identical to subsections (a) and (c) of rule 10b-5 and subsections (1) and (3) of section 17(a).¹²⁸

The Investment Advisers Act of 1940 does not provide any express remedies whatsoever.¹²⁹ Thus, the Court did not need to consider the impact of an implied right on "counterpart" provisions such as sections 12(2) and 17(a) of the 1933 Act.¹³⁰ The Court focused instead on the fact that Congress had "expressly provided both judicial and administrative means for enforcing compliance" that did not contemplate private actions for damages.¹³¹ The Court found it "highly improbable that 'Congress absentmindedly forgot to mention an intended private action.'"¹³² Finding no legislative intent mandating a contrary result, the Court held that no implied private right of action exists under section 206.¹³³

126. 444 U.S. 11 (1979). In *Transamerica* a shareholder of a real estate investment trust brought derivative and class actions against the trust, its advisers, and others, alleging fraud and breach of fiduciary duty. The shareholder argued that clients of investment advisers are intended beneficiaries of the Investment Advisers Act, and thus the Court should imply a private cause of action in their favor under § 206 of the Act. The Court refused to recognize such a right under the section despite its similarity to rule 10b-5 and § 17(a).

127. 15 U.S.C. § 80b-6 (1976). Section 206 provides in pertinent part:

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

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

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

Id.

128. Compare *supra* note 127 with *supra* notes 1 & 3.

129. 444 U.S. at 18; see 15 U.S.C. § 80b-6 (1976).

130. See *supra* notes 121-22 and accompanying text.

131. 444 U.S. at 20.

132. *Id.* (quoting *Cannon v. University of Chicago*, 441 U.S. 677, 742 (1979) (Powell, J., dissenting)).

133. 444 U.S. at 23-25. Once again the Supreme Court refused to usurp congressional powers and declined to provide an implied right when the right neither existed nor was intended under the federal securities laws. "[T]he 1970 amendments to the [Investment Company] Act is another clear indication that Congress knew how to confer a private right of action when it wished to do so." *Id.* at 23 n.13.

The Court did hold, however, that a limited private remedy exists under § 215 of the Act. Section 215 declares that contracts made in violation of the statute shall be void. 15

The *Transamerica* Court went well beyond the *Cort-Redington* threshold analysis necessary to deny the implication of a private right of action under section 17(a). The Court did not need to review the grant of express private rights in other parts of the statute for it to deny the implied action. The Court was, in effect, stating that the existence of a public means of enforcement was sufficient to raise a presumption against the existence of a private right.¹³⁴ This presumption, moreover, could be overcome only by a persuasive showing of legislative intent to the contrary.¹³⁵ Without speculating on the proof needed to meet this burden, one may safely conclude that this showing is not possible under section 17(a) because there is little legislative history concerning this section.

VI. CONCLUSION: THE COURTS AS CAVALRY

The federal courts presently construe section 17(a) to provide substantive advantages over previously favored causes of action.¹³⁶ Since the demise of rule 10b-5,¹³⁷ section 17(a) appears to be the panacea for recovery under the securities laws without the strictures of section 12(2). The willingness of the courts to assist defrauded investors by implying a private right of action under section 17(a), however, rests upon dubious legal reasoning and an unfounded reliance on *stare decisis*. This policy of "investor protection at all costs" remains deeply rooted in the judicial mind and creates a substantial imbalance in the federal securities laws. The lower courts are too willing to further the policy of investor protection at the expense of society as a whole, which ultimately bears the burden of the additional cost of raising capital.

The *Transamerica* decision, however, exemplifies the Supreme Court's emphatic desire to leave legislative questions involving risk

U.S.C. § 80b-15 (1979). The Court determined that Congress contemplated private litigation when enacting § 215 because it must have realized that the customary legal incidences of voidness—rescission, injunction, and restitution—would require resolution through private means. 444 U.S. at 18-19, 24; see also *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982) (1974 amendments to the Commodity Exchange Act do not destroy previously recognized implied private right of action for damages for violation of the Act).

134. 444 U.S. at 19-20.

135. "Even settled rules of statutory construction could yield, of course, to persuasive evidence of a contrary legislative intent." *Id.* But see *Hazen, Implied Private Remedies Under Federal Statutes: Neither a Death Knell Nor a Moratorium—Civil Rights, Securities Regulation, and Beyond*, 33 VAND. L. REV. 1333 (1980).

136. See *supra* note 36 and accompanying text.

137. See *supra* note 18.

and cost allocation to Congress. Following *Hochfelder*, the Supreme Court will presumably restrain the expansion of section 17(a) in the lower courts. Even so, the failure of the lower courts to abide by elementary tenets of statutory interpretation is disturbing and will likely continue until the Court rules on the section 17(a) question directly. This casual but conscious interference with the statutory scheme created by Congress raises serious doubts about the judiciary's perception of its role in the law. Judges may judge, interpret, and construe. They should not attempt to create the law out of whole cloth.

The impropriety of this judicial legislation is clear when one considers that the development traced in this article occurred after the Supreme Court, in *Hochfelder* and its progeny, rejected the idea that investor protection was the sole justification for the securities laws. In the final analysis, judicial notions of equity should remain subservient to those of society as reflected in the laws passed by Congress. To conclude otherwise signals the rejection of a principle fundamental to the structure of American law.

The authors hope that another twenty-five year period will not elapse before the Supreme Court reviews a section 17(a) private action case. By then, the weight of lower court precedent may once again, as in rule 10b-5, force the Court to concede that an implied private right is well-established even though in derogation of recognized statutory principles pervasive throughout the federal securities laws.¹³⁸

138. The potential for decision rests with the Supreme Court now in a case in which the Court recently granted certiorari, *Huddleston v. Herman & MacLean*, 640 F.2d 534, 540-41 & n.4 (5th Cir.), *modified and reh'g denied*, 650 F.2d 815 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982) (Nos. 81-680 & 81-1076). The respondent in its brief to the Court has framed in the following manner the issue as to whether § 17(a) warrants the implication of a private right of action:

Although no contemporaneous authoritative discussion provides an answer as to Congress's intent to provide an implied remedy for violations of § 10(b), the same is not true as to § 17(a) of the 1933 Act. On October 30, 1933, Commissioner Landis of the Federal Trade Commission addressed the New York State Society of Certified Public Accountants and dealt with the issue of civil liability under § 17(a) as follows:

The suggestion has been made on occasion that civil liabilities arise also from a violation of § 17, the first subsection of which makes unlawful the circulation of falsehoods and untruths in connection with the sale of a security in interstate commerce or through the mails. But a reading of this section in the light of the entire Act leaves no doubt but that violations of its provisions give rise only to a liability to be restrained by injunctive action or, if wilfully done, to a liability to be punished criminally. That such a conclusion alone is justifiably to be drawn from its provisions is a matter upon which the

commission has already made a pronouncement, the authoritative quality of which I shall occasion to consider later.

The American Accountant, "Liability Sections of Securities Act Authoritatively Discussed," November 1933, p. 332.

Further on, Commissioner Landis discusses Federal Trade Commission activity in interpreting the 1933 Act:

The United States Government, speaking this time through the agency of the Federal Trade Commission, says to an issuer—act in such a fashion and no rights, either criminal or civil, will be created against you. It would, indeed, be unusual if action and reliance upon such advice should be treated by another agency of the same government—the courts—as subjecting the parties so advised to liability. This recognition of the fact of there being something akin to estoppel present in such action by the commission, has naturally made the commission, as distinguished from its divisional officials, chary of the exercise of these powers. *Only two commission opinions have thus far been rendered, and these naturally merely make explicit what is already implicit within the Act.* (Emphasis added)

Id. at 334.

Commissioner Landis' description of the effect of Federal Trade Commission action is supported by the section of the 1934 Act which provides for the transfer of duties from the Federal Trade Commission to the Securities and Exchange Commission:

Sec. 210. Upon the expiration of sixty days after the date upon which a majority of the members of the Securities and Exchange Commission appointed under Sec. 4 of Title I of this Act have qualified and taken office, all powers, duties, and functions of the Federal Trade Commission under the Securities Act of 1933 shall be transferred to the Commission. . . . All orders, rules, and regulations which have been issued by the Federal Trade Commission under the Securities Act of 1933 and which are in effect shall continue in effect until modified, superseded, revoked, or repealed. All rights and interests accruing or to accrue under the Securities Act of 1933, or any provision of any regulation relating to, or out of any action taken by, the Federal Trade Commission under such act, shall be followed in all respects and may be exercised and enforced.

No suggestion is intended that the Court is estopped by a 1933 interpretative opinion of the Federal Trade Commission from inferring a private remedy under § 17(a). It is submitted, however, that the foregoing provides an insight into the "contemporary legal context" in which the 1933 and 1934 Acts were enacted.

Brief for Respondent at 38-40, *Huddleston*.