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Implied Private Actions for Federal Margin Violations: The Cort v. Ash Factors

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IMPLIED PRIVATE ACTIONS FOR FEDERAL MARGIN VIOLATIONS: THE *CORT v. ASH* FACTORS

INTRODUCTION

The controversy over implied private causes of action for margin violations under section 7 of the Securities Exchange Act[1] may be nearing final resolution. The Second Circuit's decision in *Pearlstein v. Scudder & German,*[2] the leading case granting a cause of action,[3] has been undermined by amendments to section 7 subjecting borrowers as well as lenders to the margin requirements.[4] Several courts have accordingly questioned *Pearlstein*'s validity,[5] including the Second Circuit itself.[6] The confusion was increased in 1975 by *Cort v. Ash,*[7] in which the Supreme Court established a four-part test to determine whether a private action should be implied for violation of a federal statute that contains no express remedy.[8] Applying the *Ash* factors, several lower courts have recently reached conflicting results on the propriety of implied section 7 actions.[9]

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1. 15 U.S.C. § 78g (1976).

2. 429 F.2d 1136 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971).

3. *Accord,* Spoon v. Walston & Co., 478 F.2d 246 (6th Cir. 1973) (per curiam); McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359 (N.D. Ga. 1977); Neill v. David A. Noyes & Co., 416 F. Supp. 78 (N.D. Ill. 1976); Evans v. Kerbs & Co., 411 F. Supp. 616 (S.D.N.Y. 1976); Teitelbaum v. Scranton Nat'l Bank, 384 F. Supp. 1139 (M.D. Pa. 1974); Golob v. Nauman Vandervoort, Inc., 353 F. Supp. 1264 (N.D. Ohio 1972); Manevich v. duPont, 338 F. Supp. 1124 (S.D.N.Y.), *aff'd per curiam,* 465 F.2d 138 (2d. Cir. 1972); Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677 (D.D.C. 1971).

4. Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301, 84 Stat. 1124 (codified at 15 U.S.C. § 78g(f) (1976)), *discussed at* notes 32-39 *infra* and accompanying text.

5. *See* Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co., 549 F.2d 164, 169-70 (10th Cir), *cert. denied,* 434 U.S. 890 (1977); McCormick v. Esposito, 500 F.2d 620, 627-28 (5th Cir. 1974), *cert. denied,* 420 U.S. 912 (1975); Gordon v. duPont Glore Forgan Inc., 487 F.2d 1260, 1263 (5th Cir. 1973), *cert. denied,* 417 U.S. 946 (1974); Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 469 F.2d 1166, 1181-82 (8th Cir. 1972); Goldman v. Bank of Commonwealth, 467 F.2d 439, 446-47 (6th Cir. 1972); Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485, 498 (S.D.N.Y. 1977); Freeman v Marine Midland Bank-New York, 419 F. Supp. 440, 451-52 (E.D.N.Y. 1976); Lantz v. Wedbush, Noble, Cooke, Inc., 418 F. Supp. 653, 654 (D. Alaska 1976); Newman v. Pershing & Co., 412 F. Supp. 463, 468-69 (S.D.N.Y. 1975); Bell v. J.D. Winer & Co., 392 F. Supp. 646, 653-54 (S.D.N.Y. 1975.)

6. Pearlstein v. Scudder & German, 527 F.2d 1141, 1145 n.3 (2d Cir. 1975) ("The effect of [the amendments to § 7] is to cast doubt on the continued viability of the rationale of our prior holding.").

7. 422 U.S. 66 (1975).

8. *See* note 62 *infra* and accompanying text.

9. The following decisions have granted a cause of action: Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,239 (S.D. Ohio 1977); Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977). *Contra,* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,528 (D. Md. Feb. 16, 1978); Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973 (S.D.N.Y. 1978); Gluck v. Frankel, 440 F. Supp. 1143 (S.D.N.Y. 1977); Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242 (E.D.N.Y. 1977); Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281 (D. Conn. 1977).

The purpose of this Note is to analyze whether implication of private remedies under section 7 is appropriate in light of *Ash*. Part I will review the history of implied causes of action for margin violations prior to *Ash*. Part II will contend that proper application of the *Ash* factors should preclude the establishment of such actions for failure to comply with the requirements of section 7.

I. THE LAW PRIOR TO *Ash*

Unregulated margin trading[10]—the unlimited purchase of securities on credit—contributed significantly to the stock market crash of 1929 and the ensuing depression.[11] Section 7 was enacted to aid in the prevention of a similar financial catastrophe; its primary purpose is to protect the national economy from excessive speculation.[12] The section grants to the Board of Governors of the Federal Reserve System (Board) the authority to regulate the maximum amount of credit that may be extended for the purpose of purchasing or carrying securities.[13]

Pursuant to its authority under section 7, the Board has placed limitations on the authority of brokers and other lenders to conduct credit transactions. Regulation T restricts the amount of credit that may be extended by broker-dealers,[14] Regulation U limits the extension of credit by banks in order to acquire certain securities if collateralized by some form of stock,[15] and Regulation G governs loans made by persons other than banks, brokers, or dealers.[16] Manifestly, section 7 and the regulations thereunder were originally

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10. The advantages to investors of margin transactions were aptly summarized by Professor Galbraith: "In the stock market the buyer of securities on margin gets full title to his property in an unconditional sale. But he rids himself of the most grievous burden of ownership—that of putting up the purchase price—by leaving his securities with his broker as collateral for the loan that paid for them. The buyer again gets the full benefit of any increase in value—the price of the securities goes up, but the loan that bought them does not. In the stock market the speculative buyer also gets the earnings of the securities he purchased." J. K. Galbraith, The Great Crash, 1929, at 24 (3d ed. 1972).

11. Solomon & Hart, *Recent Developments in the Regulation of Securities Credit*, 20 J. Pub. L. 167, 168-69 (1971). *See generally* J.K. Galbraith, *supra* note 10, at 23-27.

12. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 18, at 8 (1973) [hereinafter cited as Legislative History].

13. 15 U.S.C. § 78g(a) (1976). "For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall . . . prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security . . . ." *Id.*

14. 12 C.F.R. §§ 220.1-.130 (1978). Margin rules restrict the use of credit in market purchases by establishing a "maximum loan value" for securities purchased. The present "maximum loan value" of securities is 50%. *Id.* §§ 207.5, 220.8, 221.4. Thus, if an investor wishes to purchase stock for $5,000, he must put up at least $2,500 in collateral. If he purchases through a general account, he will have five full business days after the purchase to deposit the "margin", that is, the remainder of the purchase price. *Id.* § 220.3(b). If full payment is not received within that time, the broker must liquidate the account. *Id.*

15. *Id.* §§ 221.1-.122.

16. *Id.* §§ 207.1-.8. Every person who, in the ordinary course of his business, extends or arranges for the extension of credit totaling $100,000 or more during any calendar quarter or has

directed solely toward the extenders of credit. This provided many courts with a basis for implying private actions in favor of injured borrowers.[17] Indeed, one early decision construed the section's failure to regulate the investor as an indication by Congress that the investor required protection since he was incapable of protecting himself.[18]

The leading case prior to *Cort v. Ash* allowing private actions against lenders for section 7 violations was the Second Circuit's decision in *Pearlstein v. Scudder & German.*[19] Plaintiff had purchased bonds from defendant broker on credit, but failed to pay the balance due within seven business days after the date of purchase. Although required by Regulation T to liquidate plaintiff's account when he did not receive payment within that time,[20] defendant retained the securities, which were not sold until six months later at a substantial loss. Plaintiff sued to recover the difference between the amount he would have received had the bonds been timely sold and what he received upon their actual sale.[21] Defendant, admitting the Regulation T infraction, argued that recovery should be denied because the plaintiff had acted according to a "conscious plan to profit from the illegal extension of credit" and had induced the defendant to enter into the transaction.[22]

The majority rejected defendant's contention, stating that plaintiff's subjective knowledge of the margin requirements and his motives for entering the transaction were immaterial.[23] "[T]he danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities

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a total of $500,000 or more in credit secured by collateral that includes margin securities is subject to this regulation. *Id.* § 207.1(a).

17. *See, e.g.,* Pearlstein v. Scudder & German, 429 F.2d 1136, 1139-40 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971); Cooper v. Union Bank, 354 F. Supp. 669, 676 (C.D. Cal. 1973), rev'd on other grounds, 527 F.2d 762 (9th Cir. 1976); United States v. Van de Carr, 343 F. Supp. 993, 1013-14 (C.D. Cal. 1972); *In re* Naftalin & Co., 333 F. Supp. 136, 144-45 (D. Minn. 1971), *vacated on other grounds sub nom.* Naftalin & Co., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 469 F.2d 1166 (8th Cir. 1972); Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677, 680-81 (D.D.C. 1971); 39 Fordham L. Rev. 782, 790-91 (1971).

18. Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949).

19. 429 F.2d 1136 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971).

20. The seven day limit applies to purchases of securities in "special cash accounts." 12 C.F.R. § 220.4(c)(2) (1978). In special cash accounts, uncollateralized purchases on credit are extended by the broker upon the understanding that the customer will make full cash payment within a short time. *Id.* § 220.4(c)(1).

21. 429 F.2d at 1139. The proper measure of damages in *Pearlstein* was the subject of a later Second Circuit decision. In Pearlstein v. Scudder & German, 527 F.2d 1141 (2d Cir. 1975), the court held that the investor could recover that proportion of the stock's decline in value that the unpaid balance of the debt bore to the total purchase price. *Id.* at 1146. For example, assume that the total purchase price is $10,000 and that prior to the seven day limit the borrower paid $4,000, or 40% of the total purchase price. Defendant would be liable for 60% of the stock's decline in value between the end of the seven day period and the date the stock is ultimately sold. *Id.* at 1146 n.7. The defendant was not held liable for plaintiff's losses prior to the margin violation. Moreover, plaintiff was not entitled to recover interest, treble damages, punitive damages, or counsel fees. *Id.* at 1147.

22. 429 F.2d at 1140.

23. *Id.* at 1141.

and Exchange Commission."[24] The majority conceded that the protection of the investor was a purpose only incidental to the primary goal of protecting the national economy from excessive speculation.[25] Nevertheless, it concluded that a private action was justified because its deterrent effect would advance the statutory purpose of protecting the securities industry from margin violations.[26] The majority also held that the doctrine of in pari delicto would not bar recovery, reasoning that the regulations forbade the extension of illegal credit but not its acceptance, even when the investor has knowledge of the margin requirements.[27]

In his dissent, Judge Friendly argued that section 7 was intended only to prevent widespread margin abuse and not to protect investors. He disagreed that implication of a private action would advance the statutory purpose, noting that the Securities and Exchange Commission could effectively perform the task of enforcement.[28] Judge Friendly further reasoned that allowing

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24. *Id.*

25. *Id.* at 1140. "The main purpose of these margin provisions in section [7] is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.

"The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry . . . ." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 18, at 8.

26. 429 F.2d at 1140. The *Pearlstein* approach is not the only theory utilized to imply a private cause of action for § 7 violations. Private actions have been justified on both tort and contract theories. The leading case expounding the tort theory is Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949). In *Remar,* the defendant broker had arranged for the investor to borrow money in excess of margin requirements from a bank. In upholding plaintiff investor's right of action, the court cited § 286 of the Restatement of Torts for the proposition that "where defendant's violation of a prohibitory statute has caused injury to plaintiff the latter has a right of action if one of the purposes of the enactment was to protect individual interests like the plaintiff's." *Id.* at 1017. The *Remar* court found the requisite congressional intent in a House report which noted that protection of the investor would be achieved as a byproduct of § 7's main purpose of reducing market speculation on credit. *Id.* (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 18, at 8, *quoted at* note 25 *supra*). In dismissing the argument that the plaintiff was barred from suing because of his participation in the transaction, the court reasoned that Congress had considered him "incapable of protecting himself." 81 F. Supp. at 1017.

The contract theory for implying a cause of action for margin violations is based upon § 29(b) of the Act, 15 U.S.C. § 78cc(b) (1976), which voids any contract in violation of the Act. Section 29(b) has served as the basis for a rescission action, Warshow v. H. Hentz & Co., 199 F. Supp. 581 (S.D.N.Y. 1961), and as a defense to a broker's demand for the price of securities purchased in violation of § 7. *E.g.,* Goldenberg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959) (lender's counterclaim denied).

27. 429 F.2d at 1141. *See also* Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677, 681 (D.D.C. 1971). "The Court deplores this type of alleged investor behavior and were not the mandate of Congress so unequivocal and the public policy considerations so strong, the Court might reach a substantially different decision than the one it does. The participation, however, by plaintiff is not enough to relieve the defendant of its squarely imposed statutory duty . . . ." *Id.*

28. 429 F.2d at 1147-48 (Friendly, J., dissenting).

a plaintiff to recover losses suffered from a transaction that he knew to be illegal would induce investors to engage in margin violations.[29]

The broad reasoning in *Pearlstein,* which permits recovery even when the plaintiff is aware of the defendant's illegal conduct, prompted criticism in subsequent cases. Several courts refused to extend *Pearlstein*'s rejection of the in pari delicto doctrine to situations in which an investor entered into a conspiracy to defraud a broker[30] or deceived a lender as to the purpose of a loan.[31] Moreover, the change in legislative policy reflected in the amendment of section 7 cast further doubt on the Second Circuit's rationale.

In 1970, Congress enacted section 7(f),[32] which extended the limitations imposed on margin trading to those who borrow to acquire or maintain margin securities. Section 7(f)[33] forbids

> any United States person, or any foreign person controlled by a United States person . . . to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender (without regard to whether the lender's office or place of business is in a State or the transaction occurred in whole or in part within a State) for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if . . . the loan or other credit transaction is prohibited or would be prohibited if it had been made or the transaction had otherwise occurred in a lender's office or other place of business in a State.[34]

Although section 7(f) applies to both foreign and domestic transactions, it was primarily intended to curtail the infusion of unregulated foreign credit into the securities market.[35] Regulation X, promulgated pursuant to section 7(f), prohibits an investor from obtaining credit from within or without the United States unless the lender complies with the regulations applicable to domestic creditors.[36] It provides, however, that an innocent mistake made in

29. *Id.* at 1148 (Friendly, J., dissenting).

30. In Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968), the plaintiff had entered into a fraudulent conspiracy with employees of defendant for the purpose of placing orders for securities which he falsely represented that he could pay for. The court upheld the defense of in pari delicto. *Id.* at 459-60. Although decided prior to *Pearlstein,* post-*Pearlstein* decisions have indicated that *Moscarelli* is unaltered thereby. *See, e.g.,* Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677, 679 (D.D.C. 1971). *See also* Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 88 (S.D.N.Y. 1968), *aff'd per curiam,* 409 F.2d 1360 (2d Cir.), *cert. denied,* 396 U.S. 904 (1969) (pre-*Pearlstein* decision barring recovery when investor defrauds lender).

31. Goldman v. Bank of the Commonwealth, 467 F.2d 439 (6th Cir. 1972).

32. Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301, 84 Stat. 1124 (codified at 15 U.S.C. § 78g(f) (1976)).

33. 15 U.S.C. § 78g(f) (1976).

34. *Id.* § 78g(f)(1).

35. H.R. Rep. No. 975, 91st Cong., 2d Sess. 14, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4394, 4399; *see* Solomon & Hart, *supra* note 11, at 202-11; Comment, *Civil Liability for Margin Violations—The Effect of Section 7(f) and Regulation X,* 43 Fordham L. Rev. 93, 104-06 (1974) [hereinafter cited as *Margin Violations*]; Note, *Regulation X and Investor-Lender Margin Violation Disputes,* 57 Minn. L. Rev. 208, 215-20 (1972). Note, *Regulation X: A Complexis,* 50 Notre Dame Law. 136, 139-40 (1974) [hereinafter cited as *Complexis*].

36. 12 C.F.R. §§ 224.1-.6 (1978). Thus, an investor may not obtain credit from either a foreign or domestic bank unless the bank complies with Regulation U. *Id.* §§ 221.1-.122.

good faith by a borrower in obtaining credit shall not be deemed a violation if it is promptly remedied after discovery.[37]

The creation of borrower liability for section 7 infractions undermined the rationale for granting the investor a right to seek damages[38] and contributed greatly to the present conflict.[39] Courts questioned whether, in light of subdivision (f), the intended meaning of section 7 was the same as that attributed to it by the *Pearlstein* majority.[40] Several decisions held that section 7(f) had precluded implication of a private cause of action.[41] Others, while refusing to deny private remedies under section 7, held that the enactment of section 7(f) had effectively resurrected the in pari delicto defense which *Pearlstein* had denied.[42] Until recently, this judicial rift was exacerbated by confusion over the factors relevant to analysis of the propriety of implied actions.[43]

Regulation U provides that no bank shall extend any credit collateralized by security in an amount exceeding 50% of the security's current market value. *Id.* § 221.4.

37. *Id.* § 224.6(a).

38. The contract and tort theories of recovery were also affected by § 7(f) and Regulation X. The tort theory's assumption that § 7 was intended to benefit investors is questionable in light of § 7(f)'s inclusion of borrowers in the regulatory scheme. Even if a court determines that an implied action is proper notwithstanding § 7(f), a defendant lender should be able to raise an in pari delicto defense if the plaintiff investor has violated § 7(f). *See Margin Violations*, *supra* note 35, at 106-13. Furthermore, the investor's illegal conduct should preclude rescission under § 29(b). Freeman v. Marine Midland Bank-New York, 419 F. Supp. 440, 452 (E.D.N.Y. 1976); *see* Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,573, at 94,405 n.14 (S.D.N.Y. Oct. 4, 1978). Given the equitable nature of a rescission action, it would seem that a defendant could raise an "unclean hands" defense to bar recovery by a plaintiff guilty of a § 7 infraction. For a full discussion of the effects of Regulation X on these two theories of liability, see *Complexis*, *supra* note 35, at 144-45, 148-51.

39. For example, the Tenth Circuit in Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co., 549 F.2d 164, 170 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977), held that the enactment of § 7(f) and the promulgation of Regulation X effectively overruled *Pearlstein*. A constrasting result was reached by the District of Connecticut in Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977), in which the court held that an investor may maintain a cause of action against his broker for a § 7 violation. It found that § 7(f)'s only effect on *Pearlstein* was to resurrect the in pari delicto defense. *Id.* at 922. *See also* Lantz v. Wedbush, Noble, Cooke, Inc., 418 F. Supp. 653, 654 (D. Alaska 1976).

40. The Second Circuit itself noted that the enactment of § 7(f) cast doubt on the validity of its decision in *Pearlstein*. *See* note 6 *supra* and accompanying text. *See also* Freeman v. Marine Midland Bank-New York, 419 F. Supp. 440, 452 (E.D.N.Y. 1976).

41. *See, e.g.*, Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co., 549 F.2d 164, 169-70 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977); Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485, 499-501 (S.D.N.Y. 1977).

42. *See, e.g.*, Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977); Lantz v. Wedbush, Noble, Cooke, Inc., 418 F. Supp. 653 (D. Alaska 1976). At least one court felt compelled to adhere to *Pearlstein* regardless of § 7(f). *See* Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,239, at 92,614 (S.D. Ohio 1977).

43. *Compare* Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) *with* Landry v. Hemphill, Noyes & Co., 473 F.2d 365 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973).

II. THE *Cort v. Ash* FACTORS

Until *Cort v. Ash,*[44] no uniform set of standards had been devised by federal courts for determining whether to imply private actions for violation of a federal statute that grants no express remedy. The two-pronged test introduced in *J.I. Case Co. v. Borak*[45] found early acceptance. *Borak* involved an alleged violation of Securities Exchange Act section 14(a),[46] which prohibits the use of false or misleading proxy statements. Despite Congress' failure to provide expressly for a private action, the Court held that the protection of investors such as the plaintiff was one of the main objectives of section 14(a).[47] In addition, it found that judicial relief was necessary to achieve the purposes of the statute.[48] Thus, under the *Borak* approach, when one of the main purposes of the statute is to protect the plaintiff and the purposes of the statute cannot be achieved absent private enforcement, a private action should be implied. In *National Railroad Passenger Corp. v. National Association of Railroad Passengers (Amtrak)*,[49] however, decided ten years after *Borak,* the Court focused on three factors in denying a private action under section 307(a) of the Rail Passenger Service Act of 1970:[50] legislative history, tenets of statutory construction, and the legislative purpose of the Act.[51] Both *Borak* and *Amtrak* failed to define the relative importance of their respective requirements, thereby creating considerable confusion in subsequent decisions.[52]

In an effort to dispel the confusion, the Supreme Court articulated a four-part test in its 1975 decision of *Cort v. Ash.*[53] In that case, plaintiff Ash instituted a stockholder's derivative suit against Bethlehem Steel Corporation.

44. 422 U.S. 66 (1975).

45. 377 U.S. 426 (1964).

46. 15 U.S.C. § 78n(a) (1976).

47. 377 U.S. at 431-32. The Court determined that private enforcement was a "necessary supplement" to the action taken by the Securities and Exchange Commission. Since the Commission is unable to examine all proxy statements as carefully as it would like to, undetected mistakes are inevitable. The possibility of a large damages suit by a stockholder for a material misrepresentation may, however, provide the corporation with the incentive to scrutinize carefully the proxy statement prior to its issuance. *Id.*

48. *Id.* at 432-33.

49. 414 U.S. 453 (1974).

50. 45 U.S.C. § 547(a) (1970). The section expressly authorized only an action by the Attorney General and a limited private cause of action in cases involving labor disputes.

51. 414 U.S. at 458-64. First, the Court found nothing in the legislative history to warrant the implication of a private action in favor of a passenger. *Id.* at 457. Second, the principle of statutory construction applied declares that when the legislation expressly provides a particular remedy or remedies, Congress intended to exclude all other remedies. Thus, since § 307(a) of the Act provided for private actions by aggrieved employees but did not expressly grant passengers similar rights, the Court refused to infer a private action. *Id.* at 461. The Supreme Court later rejected this tenet in Cort v. Ash, 422 U.S. 66, 82 n.14 (1975). Third, the purpose of the statute was to eliminate uneconomic routes in an effort to achieve economic viability in the rail passenger system. To permit a passenger to bring suit to halt the discontinuance of a passenger train would frustrate that purpose. 414 U.S. at 463-64.

52. *Compare* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) *with* Securities Investors Protection Corp. v. Barbour, 421 U.S. 412, 418-22 (1975).

53. 422 U.S. 66, 78 (1975).

Ash alleged that the directors of the corporation had expended corporate funds for political advertisements in violation of the Federal Election Campaign Act of 1971.[54] The district court, in denying Ash's request for a preliminary injunction, found that the primary purpose of the statute was to destroy the influence of corporations over the national election process through campaign contributions; the protection of stockholders was only a secondary concern.[55] The court therefore refused to infer a private cause of action. The Third Circuit reversed, utilizing a two-part test.[56] First, the statute must be "designed to protect plaintiff from the harm he alleges."[57] According to the Third Circuit, Ash's status as a voter and a citizen made him an intended beneficiary of the election statute. In addition, as a stockholder, he stood to lose from the illegal expenditures from the corporation's treasury. The statute was thus "clearly" designed for plaintiff's protection.[58] Under the court's second criterion, the requested relief must be consistent with the statute's objectives.[59] Because of the often covert nature of political contributions, the court found that government enforcement alone might prove insufficient to remedy all violations. A private cause of action would therefore be consistent with the effectuation of the statutory goals.[60]

The Supreme Court unanimously reversed,[61] and declared that the propriety of implying private actions is determined according to the following criteria:

> First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted' . . . that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And, finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?[62]

It is submitted that application of these factors to section 7 mandates the denial of private actions to remedy its violations.

A. *The Class of Benefitted Plaintiffs*

Under the first criterion plaintiff must be a member of the class "for whose *especial* benefit the statute was enacted." This requisite marks a departure from prior approaches which would sanction the maintenance of a private

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54. *See* 18 U.S.C. § 610 (1970 & Supp. III 1973) (current version at 2 U.S.C. § 441b (1976)).

55. Ash v. Cort, 350 F. Supp. 227, 231 (E.D. Pa. 1972).

56. Ash v. Cort, 496 F.2d 416 (3d Cir. 1974). The Third Circuit upheld the lower court's denial of the preliminary injunction but reversed the decision granting defendant summary judgment. *Id.* at 421-24.

57. *Id.* at 422.

58. *Id.* The court held that although it may be improper to imply a cause of action in favor of an incidental beneficiary, protection of the plaintiff need not be the statute's primary purpose in order to imply a cause of action. *Id.* at 423.

59. *Id.*

60. *Id.*

61. Cort v. Ash, 422 U.S. 66 (1975).

62. *Id.* at 78 (citations omitted).

action when the plaintiff's protection was only a secondary concern of the statute.[63] The more stringent test adopted in *Ash* reflects the Supreme Court's increasing reluctance to extend access to the federal judicial forum.[64] Moreover, even upon a finding of especial benefit, courts can deny the cause of action based upon a statutory intent or purpose to the contrary.[65]

In *Ash*, the Supreme Court held that the criminal statute which prohibited corporate contributions to political campaigns conferred no federal right of action on corporate stockholders. The principal purpose of the statute, according to the Court, was to curtail corporate influence over elections; the protection of stockholders was at best an ancillary objective.[66]

The Court applied similar reasoning a year later in deciding *Piper v. Chris-Craft Industries, Inc.*[67] In *Piper*, an unsuccessful tender offeror brought suit for damages and injunctive relief against the management of the target corporation, alleging, *inter alios*, violations of section 14(e)[68] of the Exchange Act. Enacted in 1968 as part of the Williams Act,[69] section 14(e) prohibits persons engaged in making or opposing tender offers from making any untrue statement of a material fact or omitting to state a material fact that is necessary in order to make the statement not misleading.[70] The legislative history of section 14(e) indicates that its sole purpose is to protect the stockholders of the target company.[71] Therefore, the Court held, Chris-Craft Industries, as a defeated tender offeror, was not an intended beneficiary of the statute and surely not one for whose *especial* benefit the statute was enacted."[72] The Court further noted that section 14(e) regulates the conduct of tender offerors; thus it could not cogently be argued that the party whose activities the statute controls should be deemed a beneficiary of the statute.[73]

The *Piper* reasoning would seem to dictate a similar result when applied to a

63. *See, e.g.*, Wyandotte Transp. Co. v. United States, 389 U.S. 191 (1967); J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

64. *Cf.* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977) (Court was reluctant to recognize a cause of action which would promote subsidiary purpose of the statute). *See also* Note, *Private Causes of Action Under Section 206 of the Investment Advisers Act*, 74 Mich. L. Rev. 308, 315 (1975).

65. For example, in National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers, 414 U.S. 453 (1974), *discussed at* notes 49-51 *supra* and accompanying text, the purpose of the statute allowing railroads to eliminate unprofitable routes was to benefit rail passengers by providing an economically viable railroad system. The Court held that to allow a passenger to seek an injunction to halt the discontinuance of a route would frustrate the statutory purpose. *Id.* at 463.

66. 422 U.S. at 80-81.

67. 430 U.S. 1 (1977).

68. 15 U.S.C. § 78n(e) (1976).

69. Act of July 29, 1968, Pub. L. No. 90-439, §§ 2-3, 82 Stat. 454 (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976)).

70. *Id.*

71. Piper v. Chris-Craft Indus., Inc., 430 U.S. at 35; *see* S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); 113 Cong. Rec. 854 (1967) (remarks of Sen. Williams).

72. 430 U.S. at 37 (quoting Cort v. Ash, 422 U.S. at 78).

73. "As a party whose *previously unregulated* conduct was purposefully brought under federal control by the statute, Chris-Craft can scarcely lay claim to the status of 'beneficiary' whom Congress considered in need of protection." *Id.* (emphasis added).

discussion of the beneficiaries of section 7. In *Pearlstein*, the Second Circuit held that Congress viewed the protection of individual investors as only an incidental purpose of the statute.[74] The statute's primary purpose was to protect the national economy from an overextension of credit in the securities market.[75] The Board's regulations controlling the lending activities of brokers, dealers, and banks in connection with the purchase of securities are also consistent with the desire to safeguard the nation's fiscal well-being, but do not seem intended for the primary benefit of any particular class of persons.[76] Indeed, by assuring investors that losses sustained through margin speculation may be recouped in an action for damages, a private right of action would seem to detract from the purpose of the statute to control such activity.

The enactment of section 7(f), and the promulgation of Regulation X thereunder, also indicate that investors are not the primary beneficiaries of section 7.[77] Congress elected to subject borrowers to margin requirements as a means of controlling the intrusion of foreign credit into the national securities market.[78] A credit-seeking investor must now comply with the margin requirements or face criminal penalties—a position virtually identical to that of the creditor who enables him to purchase or maintain the securities.[79] Comparison with the Court's reasoning in *Piper* is instructive. Section 14(e) placed the duty of compliance on the defeated tender offeror, who now sought to take advantage of its provisions.[80] Just as that section was held not to create a cause of action in favor of those whom it regulates, a private remedy

74. Pearlstein v. Scudder & German, 429 F.2d 1136, 1140 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971); *see* note 25 *supra* and accompanying text.

75. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 18, at 8; *see* Solomon & Hart, *supra* note 11, at 168-69; Comment, *Securities Exchange Act of 1934—Civil Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T*, 61 Mich. L. Rev. 940, 944-47 (1963). Congressional hearings prior to the enactment of the Act documented the "close relationship between securities credit and stock prices, and the potentially destabilizing economic effects of sharp swings in the stock price level." Solomon & Hart, *supra* note 11, at 169.

76. *See* Pearlstein v. Scudder & German, 429 F.2d 1136, 1148 (2d Cir. 1970) (Friendly, J., dissenting), *cert. denied*, 401 U.S. 1013 (1971); Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242, at 92,631 (E.D.N.Y. 1977); Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281, at 92,802 (D. Conn. 1977). *But see* McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359, 364 (N.D. Ga. 1977); note 133 *infra* and accompanying text.

77. *See* H.R. Rep. No. 975, 91st Cong., 2d Sess. 14, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4394, 4399.

78. "When foreign financial secrecy is imposed upon the natural complexity of some of these transactions, it is virtually impossible for the Securities and Exchange Commission to know whether any laws are being violated. Moreover, the Securities and Exchange Act of 1934 is primarily a disclosure act and with foreign financial secrecy, there can be no full disclosure. This legislation will remedy much of this problem by extending the applicability of margin requirements under section 7 of the Securities Exchange Act to the purchasers of stock as well as to broker-dealers and financial institutions who lend money for that purpose." H.R. Rep. No. 975, 91st Cong., 2d Sess. 14, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4394, 4399; *see* notes 32-39 *supra* and accompanying text.

79. Regulation X does exempt investors from § 7 liability for innocent mistakes made in good faith which are promptly rectified upon discovery. 12 C.F.R. § 224.6(a) (1978).

80. *See* note 73 *supra* and accompanying text.

should not be available to investors subject to the requirements of section 7(f).

The status of investors as incidental beneficiaries of section 7 should thus preclude an implied action under *Ash*'s "especial benefit" requirement. The Eastern District of New York, relying on this first criterion, has held that no private cause of action will lie against a broker who violates the mandates of section 7.[81] The court stated simply that section 7 was not intended especially to benefit the purchasers of margin securities.[82] The District of Connecticut, however, in apparent disregard of the *Ash* standards, implied a cause of action despite acknowledging that investor protection was a byproduct of the statute.[83] The court found that private investors are within the class intended to benefit from section 7, and that margin violations would go unreported absent private enforcement.[84] That decision ignores section 7(f)'s clarification of the legislative policy subsequent to *Pearlstein,* and incorrectly equates incidental purpose with "especial benefit."[85]

B. *Legislative Intent*

An express legislative intent to create or deny a cause of action is dispositive on the private remedy issue.[86] Where no express legislative intent to create a private action may be found, courts are forced to search for evidence of implicit intent.[87] In many instances the quest may prove futile. However, the Supreme Court in *Ash* made it clear that absence of legislative intent is not conclusive; courts may still imply private causes of action if appropriate under the other three factors.[88]

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81. Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242 (E.D.N.Y. 1977).

82. *Id.* at 92,631.

83. Palmer v. Thomson & McKinnon, Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977). Similarly, the Northern District of Georgia in McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359 (N.D. Ga. 1977), ignored the *Ash* standards in implying a cause of action. The court held that an investor who is "affirmatively misled by his broker into believing that his account is in compliance with Regulation T" should be granted a private cause of action to recover any losses he suffered as a result of the violation. *Id.* at 365; *cf.* Neill v. David A. Noyes & Co., 416 F. Supp. 78, 80 (N.D. Ill. 1976) (innocent plaintiffs may bring action). Factors such as the innocence of the investor or the fraudulent conduct of the creditor, however, are irrelevant under the *Ash* standards.

84. Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977). The court relied on Regulation X, *see* note 79 *supra,* to find that § 7(f) does not alter the *Pearlstein* holding. 427 F. Supp. at 921.

85. Ironically, six months after the *Palmer* decision the District of Connecticut found it "self-evident that § 7(c) was not enacted for the especial benefit of the investor plaintiff and therefore did not create a federal right in his favor . . . ." Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281, at 92,802 (D. Conn. 1977).

86. Cort v. Ash, 422 U.S. 66, 82 (1975).

87. *See, e.g.,* National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers, 414 U.S. 453, 458-61 (1974).

88. 422 U.S. at 79-80, 82; *see* Note, *Private Causes of Action Under Section 206 of the Investment Advisers Act,* 74 Mich. L. Rev. 308, 316-20 (1975).

The Court in *Ash* also acknowledged that if it is clear that Congress intended to grant federal rights to a certain class of plaintiffs, to find an additional intent to create a private remedy in that class is not necessary.[89] Thus, the Court in *Borak* found no need to search for an implied intent to create a private action after concluding that section 14(a) created federal rights in stockholders.[90] However, a legislative intent to deny a private action to a class will control even when the statute expressly confers rights in that class.[91]

When it is at least questionable whether a plaintiff has been provided with federal rights, legislative intent should be examined.[92] For example, the *Ash* Court, once accepting the legislation's primary concern with corporate influence on elections and not the corporation's relationship with its stockholders,[93] found it unclear whether Congress intended to vest plaintiff with federal rights. Similarly, since the primary purpose of section 7 is not to protect investors,[94] it is not clear whether the investor is given federal rights. Therefore, an examination of legislative intent is appropriate.

Early Senate proposals concerning margin requirements attempted to protect the investor as well as to regulate the economy.[95] Under heavy criticism,[96] this plan was abandoned in favor of the House of Representatives' proposal which subordinated investor protection to the attainment of the broader objectives of proper utilization of national credit resources.[97] The legislative history of section 7, however, does not indicate that Congress considered the issue of private causes of action. Several interpretations have been attached to this silence. One district court has noted that since Congress had considered the need to protect the investor and failed expressly to furnish him with a private remedy, an intent to deny him a cause of action is properly inferred.[98] Such reasoning, however, has not proved ineluctable in past implied action controversies. For example, Congress was cognizant of the need to protect shareholders in enacting section 14(a) but failed to provide an express remedy for their detrimental reliance on misleading proxy state-

89. 422 U.S. at 82.

90. 377 U.S. at 432. The Court reasoned that since one of the chief purposes of the statute is to protect investors, judicial relief must be available when necessary to achieve the desired result. *Id.*; *see* notes 121-23 *infra* and accompanying text.

91. Cort v. Ash, 422 U.S. at 82.

92. *Id.* at 82-83.

93. *Id.*

94. *See* note 25 *supra* and accompanying text.

95. *See, e.g.*, S. Rep. No. 1455, 73d Cong., 2d Sess. 11 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 21, at 11.

96. *See, e.g.*, *Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 509-10 (1934) *reprinted in* 9 Legislative History, *supra* note 12, Item 23, at 509-10 (statement of John Dickinson).

97. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 18, at 8. "[C]onsiderations which affect not a general national credit policy, but only the safety of a particular stock transaction from the standpoint of a particular lender and particular borrower—are unimportant." *Id.*

98. Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242, at 92,630 (E.D.N.Y. 1977).

ments.[99] It is nevertheless uncontroverted that section 14(a) supports the implication of a private right of action brought by a shareholder.[100]

Another district court, in denying a cause of action for section 7 violations, relied upon a statement in *Ash* that when a plaintiff's status as a special beneficiary under the statute is questionable, congressional silence should be interpreted to allow state law to control the relationship.[101] Unlike the director-shareholder relationship present in *Ash*,[102] however, the relationship of margin lender and borrower is not one traditionally governed by state law.[103] Thus, utilizing Congress' silence to deny an action under section 7 may to that extent be an inappropriate application of the *Ash* standards.

Congress' intention to establish private remedies for margin violations became more questionable with the enactment of section 7(f). As noted above, the congressional proponents of section 7(f) sought to regulate the influx of foreign credit into the securities market.[104] The original version of section 7 did not refer to foreign creditors, and at least one court had interpreted this silence to indicate that the regulations passed by the Board controlling banks and other lenders did not apply to institutions located outside the United States.[105] It later became apparent that an amendment was necessary to curtail the potential destabilizing effect of foreign credit on the market.[106] The enactment of section 7(f) indicates Congress' determination that the regulation of borrowers was the most expeditious way to control foreign lenders.[107]

Since section 7(f) places a duty of margin compliance upon the borrower,[108] it is arguable that Congress intended that he be given no private remedy. A similar argument was adopted in *Piper*. After examining the legislative history of section 14(e), the *Piper* Court concluded that it evinced an intent to

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99. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964).

100. *Id.* at 433.

101. Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281, at 92,802 (D. Conn. 1977) (citing Cort v. Ash, 422 U.S. at 82-83).

102. *See* note 137 *infra* and accompanying text.

103. *See* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,528, at 94,089 (D. Md. Feb. 16, 1978); Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242, at 92,630 (E.D.N.Y. 1977).

104. *See* note 35 *supra* and accompanying text.

105. Metro-Goldwin-Mayer, Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969). Prior to *Transamerica*, it had been inferred that if a transaction had an effect in the United States, the Securities Exchange Act applied. *See* Roth v. Fund of Funds, Ltd., 279 F. Supp. 935 (S.D.N.Y.), *aff'd*, 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969) (foreign based mutual fund found liable for violation of Securities Exchange Act).

106. *Foreign Bank Secrecy and Bank Records: Hearings on H.R. 15073 Before the House Comm. on Banking and Currency*, 91st Cong., 1st & 2d Sess. 23 (1969-1970) (statement of Robert M. Morganthau).

107. "Through a simple device of making the margin requirements applicable to the borrower as well as to the lender, we will be equipping the Securities and Exchange Commission . . . with sufficient legal and investigative weapons to require adequate disclosure of foreign financing." 116 Cong. Rec. 16954 (1970) (statement of Rep. Patman, Chairman of the House Committee on Banking and Currency). *See also* H.R. Rep. No. 975, 91st Cong., 2d Sess. 14, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4394, 4399; S. Rep. No. 1139, 91st Cong., 2d Sess. 9-10 (1970).

108. *See* notes 32-37 *supra* and accompanying text.

curb the unfettered activities of tender offerors.[109] This purpose, the Court reasoned, "negate[d] the claim that tender offerors were intended to have additional weapons in the form of an implied cause of action for damages, particularly if a private damages action confers no advantage on the expressly protected class of shareholders-offerees . . . ."[110] Similarly, granting a cause of action under section 7 to the same investors that it regulates would seem not to advance the primary statutory purpose of protecting the national economy, and to that extent would be inconsistent with the legislative objectives.

Although such reasoning is appealing, the obvious flaw of attempting to construe congressional silence stems from its purely suppositional nature. In sum, little can be gleaned from section 7's legislative history other than its purpose to safeguard the national economy from the infusion of unregulated credit into the securities market. Indeed, many courts have admitted the shortcomings of implying a congressional intent when none exists.[111] According to at least one commentator, "judicial attention should focus not on what Congress might have intended by its silence, but, rather, on how best to remedy a private injury caused by conduct which Congress did expressly prohibit."[112] Before determining "how best to remedy a private injury," however, the *Ash* criteria dictate a preliminary finding that such injury should indeed be remedied. An examination of the consistency of the private action with the legislative purpose may aid in that determination.

C. *Consistency with the Statutory Purposes*

The third factor enunciated by the *Ash* Court is whether the proposed remedy is consistent with the purposes of the legislative scheme. Obviously, an express legislative provision for or against a private remedy obviates a discussion of the consistency of the remedy with the statutory purpose.[113] When, however, the legislative intent does not preclude such an action, the third factor acquires significance in the final determination.

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109. 430 U.S. at 38.

110. *Id.*

111. Such shortcomings arise from the often unreliable nature of statements contained in legislative history. Thus, in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976), the Court declared that statements by persons other than the drafters of a statute made during legislative debate or hearings are entitled to little consideration. Similarly, in United States v. O'Brien, 391 U.S. 367 (1968), the Court acknowledged the hazards of inquiring into congressional motives. "What motivates one legislator to make a speech about a statute is not necessarily what motivates scores of others to enact it, and the stakes are sufficiently high for us to eschew guesswork." *Id.* at 384; *accord,* Note, *Emerging Standards for Implied Actions Under Federal Statutes,* 9 U. Mich. J.L. Ref. 294, 310 (1976).

112. Pillai, *Negative Implication: The Demise of Private Rights of Action in the Federal Courts,* 47 U. Cin. L. Rev. 1, 26 (1978). Professor Pillai states that courts should be permitted to redress grievances resulting from statutory violations unless Congress expressly provides otherwise. *Id.* at 24. If Congress desired to deny or curtail private remedies it would do so expressly, and no negative inference should arise from Congress' failure to provide an explicit private remedy. *Id.* at 26. "Express provisions for private remedies are best understood as qualifying or relaxing adjustments to the private remedies which are implied by operation of the common law." *Id.* Thus, absent an express intention by Congress to the contrary, Professor Pillai asserts that common-law implied action principles should control. *Id.*

113. Cort v. Ash, 422 U.S. 66, 82 (1975).

Although ostensibly more lenient than *Borak*'s "necessary supplement" approach,[114] the third factor's application in *Ash* indicates that the latter is equally rigorous.[115] The *Ash* Court did not ask merely whether the implication of a cause of action would be consistent with the legislative purposes, but whether the proposed remedy would aid in the statute's enforcement.[116] The Court's probable intent was to preclude a private action unless it is necessary to effectuate the statutory objectives.[117]

The purpose of the election laws in *Ash* was to curtail corporate influence in national elections by limiting financial contributions.[118] Therefore, the Court concluded, that purpose would not be aided by a private action. Allowing the corporate stockholder to recoup the corporate funds expended would not cure the influence the funds had on the election.[119] Moreover, the Court doubted if the threat of damages would have a deterrent effect upon violators.[120] In sum, a private action was not viewed as a "necessary supplement" to public enforcement in order to attain legislative goals.

The *Borak* Court, on the other hand, found a private action to be a "necessary supplement" in the enforcement of section 14(a).[121] The purpose of section 14(a), which regulates proxy statements, is to provide the stockholder with adequate information in order for him to vote intelligently on corporate matters.[122] Because the Commission was unable to examine properly all proxy statements, the Court held that private enforcement was an essential aid to Commission action.[123]

One district court has recently relied upon the *Borak* approach to find that a private cause of action exists under section 7.[124] As noted by the dissenting opinion in *Pearlstein,* however, the purposes of section 7 render the *Borak* approach inappropriate to margin violations.[125] The primary purpose of section 7 is to provide a government agency with the power to limit the aggregate amount of credit which may be directed into the stock market and away from more economically productive uses.[126] Implication of a private cause of action would not necessarily promote these market-oriented objec-

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114. *See* note 48 *supra* and accompanying text.

115. In discussing the third factor, the *Ash* court cited *Borak* for the proposition that the remedy sought must aid the primary goal. 422 U.S. at 84.

116. *Id.; see* Comment, *Implying Private Causes of Action from Federal Statutes:* Amtrak *and* Cort *Apply the Brakes,* 17 B.C. Indus. & Com. L. Rev. 53, 69-70 (1975).

117. *See* 422 U.S. at 84.

118. *Id.* at 80-81.

119. The Court concluded that recovery of derivative damages by the corporation would not deter violations but merely permit directors to utilize corporate funds for campaign contributions and repay the corporation at a later date. *Id.* at 84.

120. *Id.*

121. 377 U.S. at 432.

122. *Id.* at 431.

123. *Id.*

124. McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359, 364 (N.D. Ga. 1977).

125. Pearlstein v. Scudder & German, 429 F.2d 1136, 1148 (2d Cir. 1970) (Friendly, J., dissenting), *cert. denied,* 401 U.S. 1013 (1971).

126. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934), *reprinted in* 5 Legislative History, *supra* note 12, Item 18, at 8.

tives.[127] Unlike an isolated violation of section 14(a), which threatens the statutory purpose to protect shareholders, an isolated violation of section 7 does not threaten to cause a significant alteration in the national credit policy. Since only widespread disregard of section 7 would adversely affect the allocation of credit in the securities market, it is unnecessary to detect every infraction.[128] Because the existing enforcement scheme is sufficient to uncover such widespread violations, creation of a private remedy is not a necessary supplement to the enforcement of section 7.[129]

The necessity of a private action to deter violations of the regulatory statute has also been found to satisfy the third criterion.[130] It is arguable that establishment of a private remedy under section 7 will prevent the growth of isolated infractions into more frequent and troublesome violations. Prior to section 7(f), however, creation of private rights of action may have been more likely to promote rather than deter violations. Assume that an investor borrowed funds to purchase securities from a lender who subsequently violated the margin requirements. If the value of the security increased, the investor could sell, pay back the loan, and enjoy the profits. If the value of the stock decreased, he could either keep the securities in the hope that their value would increase, or sell at the lower price and sue the lender to recover the difference between the value of the stock at the time of the margin violation and the amount for which they were finally sold.[131] Rather than deterring infractions, this potential "free ride" might encourage the unscrupulous investor to induce wrongful loans.

Supporters of the deterrent theory argue that section 7(f) eliminates the above consequences by subjecting the borrower to criminal sanctions for margin violations.[132] An implied cause of action would thus deter margin violations by lenders without encouraging infractions by borrowers.[133] The

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127. Pearlstein v. Scudder & German, 429 F.2d at 1147 (Friendly, J., dissenting).

128. *Id.* at 1148 (Friendly, J., dissenting); *see* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,528, at 94,089 (D. Md. Feb. 16, 1978). The *Stern* court stated: "[I]t may not be necessary to uncover all violations. The danger the Act seeks to prevent is a widespread disregard of the margin requirement sufficient to affect the general economy. The SEC can easily detect and control such widespread violations." *Id.*

129. Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,528, at 94,089 (D. Md. Feb. 16, 1978); Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242, at 92,630-31 (E.D.N.Y. 1977) ("There is nothing that leads us to believe that the Congressionally designed administrative and penal sanctions are ineffective."); *see* Pearlstein v. Scudder & German, 429 F.2d at 1148 (Friendly, J., dissenting).

130. Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977).

131. Pearlstein v. Scudder & German, 429 F.2d at 1148 (Friendly, J., dissenting) ("Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of 'heads-I-win tails-you-lose.' ").

132. *See* notes 32-39 *supra* and accompanying text.

133. McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359, 365 (N.D. Ga. 1977). *But see* Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485, 501 (S.D.N.Y. 1977) (Regulation X's exemption for innocent mistakes coupled with the admitted difficulty in determining investor's knowledge would invite investors to induce or acquiesce in the violations).

validity of the deterrence argument is suspect, however. Courts have generally refused to utilize deterrence as the sole basis to imply a private remedy.[134] The Court in *Piper* and *Ash* doubted that damages awards in fact deter statutory violations.[135] More importantly, even assuming the deterrent effect of private actions, that alone should not satisfy the third criterion of *Ash*. The fact that an implied cause of action may help prevent future violations, thereby providing a useful tool in the overall enforcement scheme, does not render such an action a necessary method of effectuating the legislative purpose of the statute.[136] It would thus appear that the possible deterrent effect of a private remedy is insufficient to satisfy the third *Ash* criterion.

D. *State Law*

The final factor set forth in *Ash* is whether the area has been traditionally relegated to state law. An implied federal cause of action may be inappropriate when a state remedy exists. In *Ash,* the Court found it significant that state law regulates the corporate director and shareholder relationship, providing shareholders with actions for ultra vires acts and breaches of fiduciary duty.[137] Moreover, the Court determined that the statutory purpose of safeguarding elections would not be undermined if control over the internal affairs of the corporation were left to state law.[138] However, a determination that the cause of action is one traditionally relegated to state law is not dispositive of the implication of a federal right. For example, the Court in *Borak* inferred a federal cause of action from section 14(a) even though state law governing proper corporate conduct extended its control to proxy statements.[139]

Most courts have found that regulations of margin trading has not historically been governed by the states,[140] and therefore that implication of a federal action would not necessarily intrude upon state law. One court has declared that, in lieu of a federal action, the states are free to provide remedies for investors injured by their lenders' wrongful margin activities.[141]

134. In rejecting the claim that the threat of damages against a successful contestant in a tender offer would provide additional protection for shareholders, the *Piper* Court noted that "even though the SEC operates in this context under the same practical restraints recognized by the Court in *Borak,* institutional limitations alone do not lead to the conclusion that any party interested in a tender offer should have a cause of action for damages against a competing bidder." 430 U.S. at 41; *see* Cort v. Ash, 422 U.S. at 84. The District of Connecticut has asserted that *Ash* tacitly rejected the argument that the third criterion is met merely because of the deterrent value of a private action. Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281, at 96,802 (D. Conn. 1977).

135. Piper v. Chris-Craft Indus., Inc., 430 U.S. at 40; Cort v. Ash, 422 U.S. at 84.

136. *See, e.g.,* Gluck v. Frankel, 440 F. Supp. 1143, 1146 (S.D.N.Y. 1977).

137. 422 U.S. at 84.

138. *Id.* at 85. Congress did not seek to regulate corporate conduct per se, but only to abrogate its import on federal elections. *Id.*

139. 377 U.S. at 434-35.

140. *See, e.g.,* Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,528, at 94,089 (D. Md. Feb. 16, 1978); Schy v. FDIC, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,242, at 92,630 (E.D.N.Y. 1977).

141. Theoharous v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,281, at 92,802 (D. Conn. 1977).

Presumably such an action could be premised on common-law theories of fiduciary duty.[142] However, to the extent that recovery would be allowed even when the plaintiff investor had violated section 7(f), the state theory of liability presumably would abrogate the purposes of the federal statute. In that instance, section 7 should preclude the adoption of the state action.[143] Thus, given the difficulty of fashioning a remedy that would not undermine section 7, states are unlikely to establish a right of recovery. Because a federal remedy would not infringe upon state regulation, the fourth factor does not counsel against implication of a private cause of action.

CONCLUSION

On balance, analysis of the *Cort v. Ash* factors suggests that no private cause of action on behalf of investors for violations by lenders of the federal margin provisions should be implied. Two of the *Ash* criteria demonstrate the impropriety of implying private remedies. First, it seems indisputable that section 7 was not enacted for the "especial benefit" of investors; second, the purposes of the statute would not be advanced by a private action. The remaining two factors do not refute this conclusion. Evidence of congressional intent to create such an action is absent from the legislative history. Admittedly, since an action by a borrower against a margin lender is not one traditionally relegated to state law, implication of a federal action would not unnecessarily duplicate local remedies. However, to do so would in no way promote section 7's primarily macroeconomic objectives, and would anomalously aid those whom it also regulates. Denial of a private action would therefore seem to be the appropriate solution.

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142. *See* Note, *Broker Dealers, Market Makers and Fiduciary Duties*, 9 Loy. Chi. L.J. 746 (1978).

143. *See* Surgil v. Kidder, Peabody, & Co., 69 Misc. 2d 213, 329 N.Y.S.2d 993 (Sup. Ct. 1971) (broker who sold plaintiff's stock in accordance with federal margin regulations need not remit profits on liquidation of the account). For a discussion of this case, see *Margin Violations*, *supra* note 35, at 110-13.