

FEDERAL JURISDICTION OVER PRIVATE SUITS ALLEGING VIOLATIONS OF STOCK EXCHANGE RULES

INTRODUCTION

The New York Stock Exchange was originally organized and operated as a private club, within the confines of which members were generally free from state and federal regulation.¹ The right to participate in Exchange activities was treated as a privilege that was extended by the Exchange to the investing public.² Investors were thus afforded virtually no protection from deceptive or fraudulent practices on the Exchange. Members often took advantage of this lack of protective regulation to engage in secret activities, thereby artificially inducing a trend in securities prices on which Exchange insiders could then speculate and profit.³ It was with an eye towards such abuse that Congress passed the Securities Act of 1933⁴ and the Securities Exchange Act of 1934.⁵

Under the 1934 Act, Congress created the Securities and Exchange Commission to oversee the securities industry.⁶ To supplement SEC supervision, the Act also provided that exchanges, as a precondition to registration, must adopt regulations to encourage conduct on the part of its members consistent with "just and equitable principles of trade."⁷ The imposition of this duty of exchange self-regulation was approved by the Supreme Court in *Silver v. New York Stock Exchange*.⁸ The duty of self-regulation imposed on the exchanges complements the duty of investor protection also created by the Securities Acts.⁹ It was these twin duties which first provided private par-

¹ Comment, 44 TULANE L. REV. 633, 635-36 (1970). See also W. DOUGLAS, DEMOCRACY AND FINANCE 67 (1940).

² Belton v. Hatch, 109 N.Y. 593, 596, 17 N.E. 225, 226 (1888).

³ See generally W. DOUGLAS, *supra* note 1, at 72.

⁴ 15 U.S.C. § 77a (1970).

⁵ *Id.* § 78a.

⁶ *Id.* § 78w.

⁷ *Id.* § 78f(b). For the text of § 6(b) see note 50 *infra*.

⁸ 373 U.S. 341, 351-52 (1961). See also Wolfson & Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CALIF. L. REV. 1120, 1124 n.23 (1970), where the authors list several advantages and disadvantages of self-regulation. In favor of this policy, the authors note that it (1) does not require an expanded governmental bureaucracy, (2) is less cumbersome than a governmental bureaucracy, (3) is more practical, (4) puts the industry directly in the regulatory process, and (5) is conducive to the development of ethical standards. *Id.* Arguments against self-regulation include: (1) businessmen do not want to regulate themselves; (2) the scheme merely replaces a large governmental bureaucracy with an equally cumbersome and more costly business bureaucracy; and (3) the policy requires the SEC to be an overseer, resulting in duplication. *Id.*

⁹ *Silver*, 373 U.S. at 352. See Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act—Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 967-68 (1966): "In addition to the general rule requiring adherence to just and equitable principles of trade . . . the self-regulators have many other rules, some of which overlap

ties with a basis for federal jurisdiction in suits brought against stock exchanges. Thus, it was early established that the federal courts acquired subject matter jurisdiction when a private party alleged a failure by an exchange to ensure that its members act in a manner consistent with the duty of investor protection, specified in the Act.¹⁰

In recent years, however, a new jurisdictional issue has arisen concerning the securities laws; namely, whether a private party may maintain an action in federal court for violation of a stock exchange rule. This issue has spawned a variety of approaches. One line of reasoning holds that there is no express jurisdictional grant for such actions in the Act itself, and the courts will not imply one, unless the private party satisfies the heavy burden of persuading the court that the exchange rule allegedly violated by the company has been accepted by the SEC as a substitute for Commission action. This approach is exemplified by the Second Circuit's decision in *Colonial Realty Corp. v. Bache & Co.*¹¹ A second approach does not emphasize the express statutory provisions, but instead asks only if the rule allegedly violated is designed primarily for investor protection. The decision of the Seventh Circuit in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹² is typical of this approach. Each approach has been followed by several courts,¹³ resulting in a degree of confusion in the area. It has also been suggested that a combination of these two approaches would be helpful.¹⁴ The Second Circuit has recently attempted such a synthesis, in *Van Gemert v. Boeing Co.*¹⁵ This decision adopts what appears to be a compromise solution to the question of federal jurisdiction for violations of stock exchange rules. In *Van Gemert*, *Colonial's* emphasis on the statutory language, and *Buttrey's* reliance on the policy of investor protection have been combined to produce a solution to the juris-

with the section 6(b) rule, adopted primarily for the protection of investors. . . . Exchanges also sign listing agreements with companies listing their securities for trading. The agreements contractually bind the issuer to do certain things (such as make prompt disclosure of material events) for the benefit of investors, and exchange policies or guides are often implemented so as to give investors additional protections."

¹⁰ *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).

¹¹ 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966). For a discussion of *Colonial*, see text at notes 27-49 *infra*.

¹² 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1960). For a discussion of *Buttrey*, see text at notes 90-103 *infra*.

¹³ For cases following the *Colonial* approach, see e.g., *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160 (S.D. Tex. 1969); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *aff'd on other grounds*, 430 F.2d 1202 (9th Cir. 1970). For cases following the *Buttrey* approach, see e.g., *SEC v. First Sec. Co.*, 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972); *Avern Trust v. Clark*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,441 (7th Cir. 1969); *Stevens v. Abbot, Proctor & Paine*, 288 F. Supp. 836 (E.D. Va. 1968). For the view that *Buttrey* and *Colonial* are not inconsistent, see *Bush v. Bruns Nordeman & Co.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶93, 674 (S.D.N.Y. 1972).

¹⁴ See *Gordon v. DuPont Glove Forgan, Inc.*, 487 F.2d 1260 (5th Cir. 1973), discussed in note 132 *infra*.

¹⁵ 520 F.2d 1373 (2d Cir.), cert. denied, U.S. , 96 S. Ct. 364 (1975).

dictional issue that is at once workable and analytically sound. *Van Gemert* incorporates the broad duty of protecting investors as the sustaining force behind a procedural framework giving exclusive federal jurisdiction to all private suits alleging a breach of stock exchange rules.

This comment will examine the historical development of implied civil liabilities under the 1934 Act for violation of a stock exchange rule. It will begin by evaluating the existence and desirability of federal subject matter jurisdiction to hear such private suits. The *Colonial* and *Buttrey* tests will then be explored to determine the impact and effect of the *Van Gemert* decision, which gives the federal courts jurisdiction to hear every private suit of this nature and thus provides a supplementary manner of supervising the securities field.

1. IMPLIED STATUTORY JURISDICTION: THE *COLONIAL* SUBSTITUTION TEST

The *Colonial*, *Buttrey* and *Van Gemert* approaches all have at their foundation section 27 of the 1934 Act,¹⁶ the basis for jurisdiction in securities cases. Section 27 provides:

The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder . . .¹⁷

The Second Circuit's approach in *Colonial* was one of strict interpretation of section 27. This approach reasons that since Congress provided for express civil remedies in sections 9(e),¹⁸ 16(b)¹⁹ and 18²⁰ of the 1934 Act the failure to do so in the other sections of the Act, such as section 27, was intentional, leaving enforcement of these areas solely to the control of the Securities and Exchange Commission (SEC).²¹ If Congress had intended private civil remedies for the violation of exchange rules, it would have expressly so provided; because no such provision appears, Congress must be deemed to have decided against such actions.²²

¹⁶ 15 U.S.C. § 78aa (1970).

¹⁷ *Id.* Although some courts have accepted the § 27 grant of jurisdiction with little comment, *see, e.g.,* *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 422 (N.D. Cal. 1968), it is a complex matter which has generated much concern. *See generally* *Hoblin, A Stock Broker's Implied Liability to its Customer for Violation of a Rule of a Registered Stock Exchange*, 39 *FORDHAM L. REV.* 253 (1970); *Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules*, 66 *COLUM. L. REV.* 12 (1966); *Shipman, supra* note 9; *Wolfson & Russo, supra* note 8.

¹⁸ 15 U.S.C. § 78i(e) (1970).

¹⁹ *Id.* § 78p(b).

²⁰ *Id.* § 78r.

²¹ *Lowenfels, supra* note 17, at 18.

²² *Id.*

An extension of this argument is that since certain sections of the 1934 Act specifically distinguish among the Act itself, rules promulgated by the SEC, and rules promulgated by the exchanges in accordance with the Act,²³ while section 27 makes no such distinction, an implication may be drawn that Congress in enacting section 27 intended to omit a violation of the exchange rules as a basis of jurisdiction.²⁴ Such restrictive interpretation of statutory language has been generally criticized by the Supreme Court.²⁵ The federal courts have found little difficulty in avoiding this approach to imply a civil remedy in analogous cases involving other sections of the Act.²⁶

In *Colonial*, plaintiffs claimed that Bache & Co., a securities broker, had violated certain exchange rules²⁷ and in so doing had acted in a manner inconsistent with just and equitable principles of trade, in violation of sections 6(b)²⁸ and 15A(b)(7)²⁹ of the 1934 Act.³⁰ The district court dismissed the securities claim, though it granted Colonial's motion for an interlocutory appeal to the Second Circuit.³¹ The issue on appeal was whether the complaint established a federal question under the Act upon which jurisdiction could be based.³² This was the first time that a circuit court was faced with the question of whether the allegation of a violation of a stock exchange rule was sufficient to establish federal subject matter jurisdiction under the Act.

The Second Circuit affirmed the district court's dismissal of the complaint.³³ The court first pointed to the absence in section 27 of an express cause of action for violation of a stock exchange rule.³⁴ The court next contrasted the explicit reference to "any provision of this title or of any rule or regulation thereunder, or of any rule of an

²³ Compare 15 U.S.C. § 78f, with *id.* § 78e and *id.* § 78cca.

²⁴ Lowenfels, *supra* note 17, at 18.

²⁵ E.g., SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943).

²⁶ See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Hooper v. Mountain States Sec. Corp. 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

²⁷ The claim was based on alleged violations of Article XIV of the Exchange Constitution, section 2(a) of the By-Laws, and Article III, section 1 of the Rules of Fair Practice, promulgated by the NASD. 358 F.2d at 179-80. Colonial alleged that Bache had misinformed the plaintiff corporation, in that the broker had said that Colonial's margin account was below the Exchange's required minimum. Also alleged was a claim that Bache had overcharged on debit balances. 358 F.2d at 179 n.1.

²⁸ For the full text of § 6(b), see note 50 *infra*.

²⁹ This section has been renumbered and is now § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (1970).

³⁰ 15 U.S.C. § 78a (1970).

³¹ 358 F.2d at 180. The district court amended its order dismissing the federal questions to allow Colonial to appeal the order under 28 U.S.C. § 1292(b) (1970), because it involved a controlling question of law. 358 F.2d at 180.

³² 358 F.2d at 180.

³³ *Id.* at 184.

³⁴ *Id.* at 181.

EXCHANGE RULE SUITS

exchange required thereby" in section 29(a) of the Act,³⁵ with the lack of a similar reference to exchange rules in section 27.³⁶

Finding no explicit grant of jurisdiction, the court proceeded to determine whether it had authority under the Act to imply a remedy. The court acknowledged the duty of the federal courts to effectuate the purposes of the Act.³⁷ Noting, however, the breadth of the section 6(b) mandate that exchange rules promote conduct in accordance with "just and equitable principles of trade," the court stated that it could not assume that Congress had intended the exchanges to be held responsible to such an amorphous standard.³⁸ In an attempt to better define the standard, the court sought to balance the twin congressional goals of industry self-regulation and investor protection. Leaning too far in concern for the investor might result in the absurdity of giving a right of recovery for violation of any and all rules, including simple "housekeeping rules."³⁹ The court viewed congressional reliance on exchange self-regulation as indicative of an intent not to automatically allow civil suits.⁴⁰ The court finally settled on the solution that breach of a stock exchange rule would serve as a basis for jurisdiction if the rule were shown to be "a substitute for regulation by the SEC itself."⁴¹ The rules involved here were held not to be such substitutes.⁴² Nonetheless, the court's test clearly suggested that violation of some rules would result in civil liability.

Apart from these problems of statutory interpretation, a more practical policy concern undoubtedly affected the *Colonial* result. This was the fear expressed by the court that implying federal civil liability for violations of exchange rules would open the federal courts to a flood of litigation,⁴³ removing from arbitration or the state courts many controversies which belonged there.⁴⁴ The court was therefore hesitant to deal in an expansive manner with the jurisdictional issue.⁴⁵

The Second Circuit did not suggest any objective test to aid in determining whether an exchange rule is a substitute for SEC

³⁵ 15 U.S.C. § 78cca (1970) (emphasis added).

³⁶ See text at note 17 *supra*.

³⁷ 358 F.2d at 181.

³⁸ *Id.*

³⁹ *Id.* at 182. See also Lowenfels, *supra* note 17, at 28-29.

⁴⁰ 358 F.2d at 181.

⁴¹ "[T]he court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or a SEC regulation." *Id.*

⁴² "We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions [catch-all rules which allow exchanges flexibility in minding their own houses] in their rules Congress meant to impose a new legal standard on members . . ." *Id.*

⁴³ "Moreover, mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits . . ." *Id.* at 183.

⁴⁴ *Id.* at 182-83.

⁴⁵ *Id.*

action.⁴⁶ One commentator has suggested a two-part test: (1) Has the SEC declined to act in the particular area, on the condition that each exchange promulgate its own rule governing the same subject matter? (2) Has the SEC promulgated a rule, applicable only to non-members, which regulates the same conduct as a similar exchange rule applicable to members? Where both these conditions are satisfied, the exchange rule would then be considered a substitute, the breach of which would give rise to civil liability.⁴⁷ An affirmative answer to either one of these questions will show that an exchange rule *may* be a substitute for SEC action.⁴⁸ Another commentator has suggested a similar three-part test: (1) Is the rule explicitly required or permitted by the Commission? (2) Is the rule implicitly traceable to specific statutory provisions? (3) Is the rule reasonably explicit and related to the goal of investor protection? Proof of these factors would establish substitution.⁴⁹

A better approach to the substitution question may be based on the broad language of section 6(b)⁵⁰ and an understanding of the relationship between the SEC and the exchanges with regard to the promulgation of rules. Section 6 provides for the registration of exchanges.⁵¹ A prerequisite of registration is that each exchange adopt rules of conduct governing its members consistent with "just and equitable principles of trade" and provide for disciplinary action in the event that a member violates these rules.⁵² At the same time that it enacted section 6(b), Congress also authorized the SEC to promulgate its own rules.⁵³ SEC rules are included in the section 27 jurisdictional grant, since they are promulgated pursuant to the Act.⁵⁴ The

⁴⁶ "[T]he court must look to the matter of the particular rule and its place in the regulatory scheme The case for implication would be strongest when the rule imposes an explicit duty unknown at common law." *Id.* at 182.

⁴⁷ Shipman, *supra* note 9, at 1007.

⁴⁸ *Id.*

⁴⁹ Wolfson & Russo, *supra* note 8, at 1136-42.

⁵⁰ Section 6(b) provides:

No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

15 U.S.C. § 78f(b) (1970).

⁵¹ Section 6(a), 15 U.S.C. § 78f(a) (1970).

⁵² *Id.*

⁵³ 15 U.S.C. §§ 78s, 78w (1970).

⁵⁴ See *id.* The exercise of this discretionary authority has been limited. See W. DOUGLAS, *supra* note 1, at 66: "[O]f all the rules now in force . . . not one was formally adopted by this Commission. True, their adoption by the Exchange was at the suggestion of the Commission but only after full consultation with the Exchange. And in no case where the Exchange refused to act did the Commission promulgate its own rule. In short, all of them are the Exchange's rules, enforceable primarily by it." For a more recent statement acknowledging this sparing use by the SEC of its discretionary author-

EXCHANGE RULE SUITS

SEC was also given the option of declining to promulgate a particular rule until after the exchanges have been given the opportunity to make their own, which must then be subjected to critical examination and approval by the SEC.⁵⁵

If the SEC explicitly approves and implements an exchange rule, the practical effect is the same as if the SEC had itself promulgated the rule. Similarly, if the SEC fails to *disapprove* an exchange rule, it has arguably authorized the rule by implication.⁵⁶ It is therefore submitted that, whether explicitly or implicitly approved by the SEC, an exchange rule should be given the same weight as a SEC rule. It should thus be included in the jurisdictional grant of section 27, and a breach of the rule should result in civil liability.⁵⁷

This expansive approach contrasts with the *Colonial* approach whereby only explicitly adopted exchange rules may be covered by section 27. However, the notion of expanding jurisdiction for suits alleging violation of exchange rules comports well with one of the goals of the 1934 Act: self-regulation by the exchanges. The Supreme Court stressed the importance of self-regulation by stock exchanges in *Silver v. New York Stock Exchange*,⁵⁸ an action brought by a non-member against the Exchange, alleging a violation of the Sherman Act.⁵⁹ Although holding that the Exchange's action in this case was violative of the antitrust laws, the Court stated that not all actions otherwise illegal under the Sherman Act would be held to be illegal if performed by the Exchange.⁶⁰ This is because the "federally mandated duty of self-policing by exchanges"⁶¹ compels the exchanges to adopt certain policies which might otherwise be suspect. Exchange actions would, however, be subject to measurement against a standard which combines *both* statutory aims; that is, it must be shown that the actions are

ity, see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 129-30 (1973).

⁵⁵ 15 U.S.C. §§ 78s, 78w.

⁵⁶ 15 U.S.C. § 78s(d) provides that: "The Commission is authorized and directed to make a study and investigation . . . of exchange rules to determine their adequacy in protecting investors." (Emphasis added.) See also *Silver*, 373 U.S. at 357.

⁵⁷ See W. DOUGLAS *supra* note 1, at 82:

[T]he national securities exchanges should be so organized as to be able to take on the job of policing their members so that it would be unnecessary for the Government to interfere with that business and that they should demonstrate by action that they were so organized. Now, that is something more than cooperation. That is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.

Id.

⁵⁸ 373 U.S. 341 (1961). Douglas' "shotgun" quote, see note 57 *supra*, was cited approvingly. *Id.* at 352.

⁵⁹ *Id.* at 360-61.

⁶⁰ The Exchange revoked temporary approval of private telephonic connections arranged between plaintiffs and members of the Exchange; the Exchange denied Silver's repeated requests for an explanation of this action. *Id.* at 343-46.

⁶¹ *Id.* at 356-57.

regulatory and are protective of investors, and that they do not absolutely offend the antitrust laws.⁶² To ensure this, "[s]ome form of review of exchange self-policing, whether by administrative agency or by the courts, is therefore not at all incompatible with the fulfillment of the aims of the Securities Exchange Act."⁶³ An expansive treatment of the substitution question is supportive of this approach, since if it can be shown that a particular rule has been explicitly or implicitly approved by the SEC; that rule will have much more authority and will better serve as a source of private enforcement input.

II. DUTIES AND LIABILITIES: *BUTTREY* AND INVESTOR PROTECTION

The Seventh Circuit, in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁶⁴ adopted an approach which concentrates on the existence of a duty owed to the investor by the exchange. The source of this duty is section 6(b), which mandates that exchanges encourage behavior by listed firms in accordance with "just and equitable principles of trade."⁶⁵ Jurisdiction thus exists under section 27, which provides jurisdiction to enforce "any liability or duty created by this title or the rules and regulations thereunder . . ."⁶⁶

*Baird v. Franklin*⁶⁷ was the first case in which a court found a duty under section 6 on the part of exchanges to discipline errant members. Plaintiffs brought an action against the New York Stock Exchange for damages suffered when a member-firm failed. The thrust of the complaint was that the exchange had neglected to ascertain that the member-firm was embezzling the plaintiffs' securities and that upon discovery of this breach of fiduciary duty the exchange did not discipline the member.⁶⁸ The district court found no duty owed to the plaintiffs by the Exchange and dismissed the complaint for lack of jurisdiction.⁶⁹

The Second Circuit reversed the district court and held that

⁶² *Id.* at 357.

⁶³ *Id.* at 359 (emphasis added). This leads to the conclusion that federal courts do have jurisdiction under § 27 for actions involving violations of security exchange rules. Yet the question remains why Congress, if it so intended, did not explicitly provide for civil remedies. It is this incongruity which made the statutory-based arguments an unsatisfactory basis of jurisdiction for the Second Circuit in *Colonial*. It appears, however, that the Second Circuit assumed that jurisdiction does exist for such suits, in reaching its recent decision in *Van Gemert*. See text at notes 133-57 *infra*.

⁶⁴ 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

⁶⁵ 15 U.S.C. § 78f(b).

⁶⁶ *Id.* § 78aa (1970) (emphasis added).

⁶⁷ 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

⁶⁸ Plaintiffs brought the action on two distinct theories of recovery. One was that, on learning that a member had violated certain exchange rules, the Exchange became liable for its failure to take disciplinary action towards the member. The second was that plaintiffs were third party beneficiaries of the agreement filed by defendant with the SEC in accordance with section 6(a)(1), 15 U.S.C. § 78f(a)(1). 141 F.2d at 242.

⁶⁹ 141 F.2d at 243.

EXCHANGE RULE SUITS

there was such a duty.⁷⁰ The court decided, however, that although the Exchange had failed in its duty, there was no ultimate liability because this failure was not a proximate cause of plaintiffs' loss.⁷¹ Judge Clark dissented in part from the result but agreed that the exchanges were bound to regulate the conduct of their members.⁷² The gist of Judge Clark's reasoning was that section 6 would be meaningless unless section 6(b) "is construed as imposing the twofold duty of enacting certain rules and regulations and of seeing that they are enforced."⁷³

Baird thus established that section 6(b) raised a duty of investor protection, which could be enforced against the exchanges in federal court under section 27.⁷⁴ The approach taken by the court necessarily involved the existence of a class to be protected (the investing public), a type of harm from which this class is to be protected (violations of Stock Exchange rules), and a remedy for that harm (civil liability).

The question of whether the duty of investor protection encompasses third parties other than the exchanges was first addressed by the Supreme Court in *J.I. Case Co. v. Borak*.⁷⁵ Plaintiffs brought suit against the J.I. Case Company alleging a violation of section 14(a) of the 1934 Act.⁷⁶ It was alleged that the plaintiff shareholders were deprived of their preemptive rights when the defendant effected a merger by circulating a false and misleading proxy statement.⁷⁷ The district court held that its jurisdiction was limited to granting declaratory relief, and that it could not award private damages.⁷⁸ The circuit court reversed, holding that the district court was empowered to award such relief.⁷⁹ The Supreme Court affirmed, holding that a federal court has jurisdiction to imply remedies that will further the aims of the Act.⁸⁰

Two considerations influenced the Court's reasoning. First, the Court noted that investor protection is a primary aim of the Act.⁸¹ In determining whether a breach of the chapter itself may be remedied by implying jurisdiction for civil suits, the question is thus whether the

⁷⁰ "We accede to the view that the Stock Exchange violated a duty when it failed to take disciplinary action." *Id.*

⁷¹ *Id.*

⁷² *Id.* at 244.

⁷³ *Id.*

⁷⁴ The plaintiff in *Colonial* had relied on *Baird*, claiming that it was unreasonable to limit to an exchange the civil liability that may be implied from § 6. It was contended that such liability should extend to a member firm. 358 F.2d at 181. The court in *Colonial* distinguished *Baird*, however, explaining that *Baird* turned on a violation of the 1934 Act itself, and not, as in *Colonial*, on a violation of an exchange rule by an exchange member. *Id.*

⁷⁵ 377 U.S. 426 (1964).

⁷⁶ 15 U.S.C. § 78n (1970).

⁷⁷ 377 U.S. at 427.

⁷⁸ *Id.* at 430.

⁷⁹ *Borak v. J.I. Case Co.*, 317 F.2d 838, 849 (7th Cir. 1963).

⁸⁰ 377 U.S. at 433.

⁸¹ *Id.* at 431-32.

implication of jurisdiction will further the goal of investor protection.⁸² That section 14(a) did not specifically provide for private civil suits was not deemed a barrier. The goal of investor protection "implies the availability of judicial relief."⁸³ Second, the court stated that "[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action."⁸⁴ The Court therefore declared it to be "the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."⁸⁵

It is important to note that the duty violated in *Borak*—the protection of investors—was considered by the Court to be one raised by the Act itself. *Borak* dealt only with section 14(a) of the 1934 Act, an individual provision which is expressly intended for the protection of investors: "[T]he Commission may prescribe [such rules] as necessary . . . for the protection of investors . . ."⁸⁶ Thus, it could be argued that *Borak* did not declare a principle of general applicability, but was instead tied to the presence of a specific declaration of congressional policy. The Supreme Court, however, in such cases as *Allen v. State Board of Elections*,⁸⁷ has not given *Borak* such a limited construction. In *Allen*, plaintiffs sought declaratory judgments concerning the validity of certain voting requirements of the states of Mississippi and Alabama. Plaintiffs alleged that these states had failed to adequately demonstrate that the enactments complied with federal law. An initial issue was whether the federal courts had jurisdiction to hear the suits, since section 5 of the Voting Rights Act of 1965⁸⁸ did not explicitly provide for private actions. In addition, the Voting Rights Act contains no language so explicitly protective of a class as the language of section 14(a). In deciding that there was jurisdiction, the Court—citing *Borak*—stated: "We have previously held that a federal statute passed to protect a class of citizens, although not specifically authorizing members of the protected class to institute suit, nevertheless implied a private right of action."⁸⁹ Thus, the Court has not linked the *Borak* analysis to the presence of particular statutory wording.

The *Borak* reasoning is the foundation of the *Buttrey* approach. In *Buttrey*, the trustee in bankruptcy for a securities dealer brought suit against Merrill Lynch for allegedly violating Rule 405 of the New York Stock Exchange, the so-called "know your customer rule."⁹⁰ Specifically, the trustee alleged that Merrill Lynch had failed to ascertain whether the bankrupt was financially stable before dealing in its

⁸² *Id.* at 432.

⁸³ *Id.* (emphasis added).

⁸⁴ *Id.*

⁸⁵ *Id.* at 433.

⁸⁶ 15 U.S.C. § 78n (1970).

⁸⁷ 393 U.S. 544 (1969).

⁸⁸ 42 U.S.C. §§ 1971, 1973 (1970).

⁸⁹ *Allen*, 393 U.S. at 557.

⁹⁰ 410 F.2d at 141.

EXCHANGE RULE SUITS

securities.⁹¹ The district court denied defendant's motion for summary judgment with respect to all counts of the claim, including the federal jurisdictional question.⁹² Defendant then sought and obtained leave to take an immediate interlocutory appeal.⁹³ The Seventh Circuit affirmed, holding that the alleged violations were actionable,⁹⁴ and leaving for consideration at trial whether there was in fact a violation of Rule 405, and whether this violation resulted in plaintiff's harm.⁹⁵

In reaching this decision, the court focused on the latter part of section 27, which grants federal jurisdiction over

all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.⁹⁶

The issue then became whether an exchange rule could raise a duty cognizable under section 27, so that the federal courts would have jurisdiction of private suits alleging a violation of the rule.⁹⁷ The Seventh Circuit, relying on *Borak*, believed that such jurisdiction existed.⁹⁸

There is nothing inconsistent with this Section [27] in holding that violations of Rule 405 may be actionable as a "duty created by this chapter" inasmuch as Rule 405 was promulgated in accordance with Sections 6 and 19 of the Act, *even if Rule 405 is not in itself to be considered a rule "thereunder."*⁹⁹

The court did not intend to fashion absolute liability for a violation of Rule 405. It recognized that this rule is capable of *both* a public protection function and a "housekeeping" role.¹⁰⁰ The care taken by the court to limit its discussion of the issue of private suits to the particular facts surrounding the instant application of Rule 405 indicates that the Seventh Circuit did not wish to formulate a general doctrine applicable to all suits alleging violations of stock exchange rules.¹⁰¹

⁹¹ *Id.* at 137, 141. This omission was aggravated when Merrill Lynch permitted the bankrupt to change from a case account to a margin account, again without any investigation of its financial security. The bankrupt began to speculate in stock transactions and defendants failed to properly supervise the account. The various losses sustained resulted in the bankruptcy. *Id.* at 141.

⁹² *Id.* at 136.

⁹³ *Id.*

⁹⁴ *Id.* at 142.

⁹⁵ *Id.* at 143.

⁹⁶ 15 U.S.C. § 78aa (1970).

⁹⁷ 410 F.2d at 143.

⁹⁸ *Id.*

⁹⁹ *Id.* at 142 (emphasis added).

¹⁰⁰ *Id.* at 141. See Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 24-25 (1966), for a discussion of housekeeping rules.

¹⁰¹ 410 F.2d at 142.

The result is that each rule allegedly breached must be examined, as was Rule 405 in *Buttrey*, to determine whether it creates a duty in favor of private parties in light of the policies underlying the 1934 Act. The touchstone for determining whether there is federal jurisdiction for suits involving a specific rule is thus the rule's design for the protection of investors.¹⁰² As in *Colonial*, the question of jurisdiction depends on a case-by-case analysis; the difference is that under *Buttrey*, the burden of persuasion is less, because the plaintiff need not show that the rule at issue is a substitute for SEC action.¹⁰³

Significantly, the *Colonial* question of whether the statute expressly creates a right of action¹⁰⁴ becomes irrelevant under the *Buttrey* approach. Through the twin congressional aims of self-regulation and investor protection, an area of duty is established which serves as the jurisdictional basis for an implied action.¹⁰⁵ Within this area the exchanges and the Commission are each charged with policing exchange members.¹⁰⁶ The non-housekeeping rules of the exchanges are standards of care by which the members are to be judged. It follows that the investor, for whose protection the Act is intended, and upon whom the various alleged harms devolve, may supplement the action of the exchanges and Commission through private suits.¹⁰⁷ The jurisdictional basis for private suits is implied in *Buttrey* from a duty "raised by the Act." The net result is a less conservative, more result-oriented interpretation of the Securities Exchange Act than was accorded by the Second Circuit in *Colonial*.¹⁰⁸

¹⁰² *Id.*

¹⁰³ In *Buttrey*, the court cited *Colonial*, but only for the narrow proposition that some rules may play an integral part in SEC regulation. *Id.* at 142. For critical comparisons of these two cases, see, e.g., Hoblin, *A Stock Broker's Implied Liability to its Customer for Violation of a Rule of Registered Stock Exchange*, 39 FORDHAM L. REV. 253, 276 (1970); Comment, MAINE L. REV. 378, 393 (1974); Comment, 1969, U. ILL. L. F. 551, 559-60; Note, U. PA. L. REV. 388, 393 (1973).

¹⁰⁴ See text at note 34 *supra*.

¹⁰⁵ 410 F.2d at 142.

¹⁰⁶ *Id.* at 142-43.

¹⁰⁷ *Id.* at 142; see *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

¹⁰⁸ It is unlikely that *Buttrey* is affected by recent actions of the Supreme Court aimed at restricting the potentially unlimited application of *Borak*. In *Cort v. Ash*, 422 U.S. 66 (1975), the Court defined four factors that should be considered in determining whether a remedy is implicit in a statutory scheme: whether the statute clearly articulates a federal right in the plaintiff, *id.* at 78; whether there is any explicit or implicit indication of legislative intent either to imply or deny a private remedy, *id.*; whether it is consistent with the legislative scheme to imply such a remedy, *id.*; and whether the type of action involved is one typically and historically of state concern, *id.* See Comment, 17 B.C. IND. & COM. L. REV. 53 (1975). In *Cort*, plaintiff shareholder brought suit under 19 U.S.C. § 610 (Supp. III, 1970), which prohibits corporate contributions in connection with any political election. The statute provides only for a criminal penalty; the Court refused to imply a private remedy. 422 U.S. at 85.

The Court, citing *Borak*, noted that the fact that the statute involved in *Cort* was penal in nature did not automatically preclude the implication of a private remedy. *Id.* at 79-80. Yet, the absence of any reference to civil actions gave rise to the presumption that protection of the class of corporate shareholders was at best a subsidiary purpose

EXCHANGE RULE SUITS

On the other hand, and possibly of even greater significance to the question of federal jurisdiction, under *Buttrey* the plaintiff retains a choice of forums. That is, since federal jurisdiction does not vest until the determination has been made whether the rule involved is directly protective of investors, the section 27 provision for exclusive federal jurisdiction¹⁰⁹ does not initially prevent the plaintiff from bringing suit in a state court. Once it has been decided that the rule allegedly violated encapsulates a duty of investor protection, however, the jurisdiction of the federal courts is exclusive. However, *Buttrey* fails to indicate any guidelines as to when or how an exchange rule may be found to be designed for the protection of investors, as opposed to a mere housekeeping rule. The result is that this jurisdictional exclusivity is determined on a case-by-case basis; there is no general rule governing the question of which forum is primary.¹¹⁰

At best, other courts have tried to de-emphasize the difference

underlying the statute. *Id.* at 80. There was found no "clearly articulated" right in the plaintiff. *Id.* at 82.

Second, if a federal law clearly grants to a class certain rights, it is not necessary that the statute also create a private cause of action. *Id.* Yet, where there is no clear grant or denial of such a right of action, and where it is questionable whether the statute does give the plaintiff certain rights, the Court will hesitate to assume a legislative function. *Id.* at 82-83. The conclusion must then be that the relationship is to be governed by state law. *Id.* at 82-84.

Further, the relief requested in *Cort* was not seen to promote the primary congressional goal in enacting the statute. While recovery might vindicate the plaintiff's monetary loss, it would do nothing to eradicate the influence exerted by misspent funds upon the election. *Id.* at 84. Finally, the Court concluded that the state court system is the proper forum for private suits of this nature. Plaintiff's claim might be nullified by applicable state law, *id.* at 84-85, or there might be additional rights of a state nature which plaintiff could invoke, such as an action for breach of fiduciary duty. *Id.* at 84. See generally Comment, 17 B.C. IND. & COM. L. REV. 53 (1975).

Cort would not bar private suits alleging violations of exchange rules. The 1934 Act does create a right in favor of a class. See *Borak*, 377 U.S. at 432; *Baird*, 141 F.2d at 239. Legislative intent to imply remedies for injuries suffered within the narrow scope of the securities laws is also clear. *Borak*, 377 U.S. at 432. Because such suits are supplementary to SEC enforcement, they are within the purview of the legislative scheme. *Id.* It is submitted that federal jurisdiction over private suits in the area of federal securities law ensures uniform national interpretation and delineation of actionable duties. Cf. *Rauch v. United Instruments, Inc.*,—F. Supp.—(E.D. Pa.), 44 U.S.L.W. 2149 (Sept. 11, 1975). Exchange rules are, to borrow the Court's words in *Cort*, 422 U.S. at 85, "clearly an intrusion into the national affairs of corporations; to the extent that state law differed or impeded suit, the congressional intent could be compromised in state-created causes of action." Thus, the reliance upon *Borak* in *Buttrey* still appears appropriate.

¹⁰⁹ "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter . . . and of all suits in equity and actions at law . . ." 15 U.S.C. § 78aa (1970).

¹¹⁰ Contrast this approach with the manner in which the Second Circuit in *Van Gemert v. Boeing Co.*, 520 F.2d 1373 (2d Cir. 1975) separated the initial jurisdictional issue from the difficult definitional question of "design for investor protection." In *Van Gemert*, federal jurisdiction attaches immediately upon allegation of a rule violation; examination of the rule for its protective function is required only in determining liability. See text at notes 142-47 *infra*.

between the approaches of *Colonial* and *Buttrey*.¹¹¹ At worst, the differences have been ignored, or the courts have seized upon "distinguishing" aspects of one decision or the other that may in fact be of no significance.¹¹² Those courts which felt that the liberal *Buttrey* decision might be more in line with congressional intent, yet which were mindful of the strict requirements of *Colonial*, sought facts tantamount to fraud to give rise to a private civil damage action.¹¹³ Others found no difficulty in rejecting civil liability arguments and denying the action altogether.¹¹⁴ Thus the existence of federal liability for violations of exchange rules by listed firms remained uncertain,¹¹⁵ with many courts hesitating to accept either approach as controlling.¹¹⁶ The result was the absence of a definitive statement of the law in this area.¹¹⁷

¹¹¹ See, e.g., *Wells v. Blythe & Co.*, 351 F. Supp. 999, 1001 (N.D. Cal. 1972); *Bush v. Bruns Nordeman & Co.*, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,674 (S.D.N.Y. 1972).

¹¹² See, e.g., *McMaster Hutchinson & Co. v. Rothschild & Co.*, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,541, at 92585 n.1 (N.D. Ill. 1972) (*Buttrey* viewed as based on an allegation of fraud).

¹¹³ *Id.* See also *Wells v. Blythe & Co., Inc.*, 351 F. Supp. 999, 1000-1001 (N.D. Cal. 1972); *Aetna Cas. & Surety Co. v. Paine, Webber, Jackson & Curtis*, [1969-70 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,748, at 99274-75 (N.D. Ill. 1970). This is a misreading of *Buttrey*, where the presence of action "tantamount to fraud" was to be weighed when considering liability. 410 F.2d at 143. There was jurisdiction in *Buttrey* once it was found that the protective functions of Rule 405 had been violated. *Id.* at 142. In this respect, see *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969).

¹¹⁴ See, e.g., *McMaster Hutchinson & Co. v. Rothschild & Co.*, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,541, at 92585 (N.D. Ill. 1972).

¹¹⁵ See *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F. Supp. 678 (D. Wyo. 1975).

¹¹⁶ See *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971); *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F. Supp. 678 (D. Wyo. 1975); *Starkman v. Seroussi*, 377 F. Supp. 518 (S.D.N.Y. 1974).

¹¹⁷ *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160 (S.D. Tex. 1969), was a case involving alleged violations of the NASD "suitability rule," Article III, Section 2, which provides that NASD members shall have a reasonable ground for recommending the sale or purchase of any security. The court followed *Colonial* and *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), in concluding that there is no jurisdiction in federal courts for suits such as these. Critical to this decision was the breadth of the "suitability rule." Were the court to imply civil liability, it would be regulating along a much broader spectrum of broker behavior than is involved in legislative security regulation. *Mercury Inv. Co. v. A.G. Edwards & Sons*, *supra*, at 1163. Even more chaotic would be the result of judicial review of market judgments. *Id.*

Mercury was followed in *Wells v. Blythe & Co.*, 351 F. Supp. 999 (N.D. Cal. 1972), where the court held that, following the mandate of *Colonial*, and absent any allegations of "fraudulent and manipulative acts and practices," which, apparently, might lead the court to follow *Buttrey's* lead, it would grant dismissal of the cause of action which had been predicated on a federal civil liability theory. *Id.* at 1002.

Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678 (D. Wyo. 1975), is a case which was filed in the District Court of Wyoming involving alleged violations of the same "suitability" rule of the NASD as was involved in *Mercury*, as well as violations of Rule 405 of the New York Stock Exchange. The court attempted to reconcile *Colonial* and *Buttrey*, but seemed instead to follow *Buttrey*, denying a motion to dismiss the federal claims based on the alleged violations. *Id.* at 683. The court still required action "tantamount to fraud," *id.*, but this would appear to be a misreading of

EXCHANGE RULE SUITS

III. A SYNTHESIS OF THE COLONIAL AND BUTTREY APPROACHES: VAN GEMERT

In *Van Gemert v. Boeing Co.*,¹¹⁸ the Second Circuit abandoned the strict interpretation approach of *Colonial* and adopted one closer to that of *Buttrey* and *Borak*. The Second Circuit began to retreat from *Colonial* in 1970, when it decided *Pearlstein v. Scudder & German*.¹¹⁹ In *Pearlstein*, plaintiff sued defendant securities partnership for damages allegedly caused by violations of section 7(c) of the 1934 Act¹²⁰ and of Regulation T.¹²¹ Defendant arranged bank loans to help finance the purchase by plaintiff of convertible bonds. Even with the loans, plaintiff failed to tender sufficient cash to purchase the bonds, and defendant extended credit to cover the deficit.¹²² There were indications that plaintiff knew or should have known that defendant was acting illegally in setting up this credit arrangement.¹²³ The district court held that plaintiff had the right to maintain the suit but that certain

the *Buttrey* holding. See note 82 *supra*. Nonetheless, *Geyer* found that the only limitations on allowing private suits under § 27 are that the exchange rule on which suits are based must not be a "housekeeping" rule, that it be precise, and that it be protective of investors. *Id.*

Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974), dealt with the question of whether an alleged violation of exchange rules is sufficient to establish jurisdiction under the Act so as to avoid enforcement of an arbitration agreement. The court noted that the reference in § 27 to "rules and regulations" might not include exchange rules, but decided that a violation of these rules might be actionable as a breach of a duty of care raised by the 1934 Act itself, and cited to *Buttrey* as authority for this proposition. *Id.* at 523. The court then shifted its attention to *Colonial*, and held that an allegation of a violation of a rule as concise as the one involved is sufficient to carry the *Colonial* burden of persuasion:

The rule which *Seroussi* is charged with violating is not a broad generalized one, "something of a catchall" with vague or uncertain contours that may lend itself to variant interpretation, so that it could reasonably be argued that it was beyond Congressional purpose that its violation would give rise to a civil claim under federal law. The rule here is precise Plaintiff's allegations which specify the details of violations of the Stock Exchange rules . . . upon their face are sufficient to confer jurisdiction under section 27 of the Exchange Act.

Id. at 523-24. The *Starkman* court thus cited to *Colonial* for authority as to the burden of persuasion, *id.*; but to *Buttrey* for the broader proposition that an allegation of a violation of an exchange rule will confer jurisdiction on the federal courts, *id.* at 523 n.22, 524 n.30. *Starkman* in this respect presaged *Van Gemert*, which found that jurisdiction in such suits always exists. 520 F.2d at 1382.

Starkman also follows *Borak* by endorsing private suits as an aid to the Commission in its task of regulating the securities industry. The court noted that suits based on a violation of a rule aimed at ensuring fair dealing and protection of investors "may be equated to anti-trust litigation, where plaintiffs have been considered 'private Attorneys General' . . ." *Starkman v. Seroussi*, *supra*, at 523.

¹¹⁸ 520 F.2d 1373 (2d Cir.), *cert. denied*, U.S., 96 S. Ct. 364 (1975).

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

¹²⁰ 15 U.S.C. § 78g(c) (1970).

¹²¹ 12 C.F.R. § 220.4(c)(2) (1975).

¹²² 429 F.2d at 1138.

¹²³ *Id.*

stipulations of judgment entered into by the parties regarding the sum owed defendant by plaintiff were *res judicata*.¹²⁴ The Second Circuit disagreed with this latter conclusion, but agreed that plaintiff could maintain the action in federal court.¹²⁵

This decision was based on the court's understanding that private suits are an "effective means of protecting the economy as a whole."¹²⁶ Interestingly, plaintiff's alleged lack of innocence did not bar recovery. Indeed, this factor was deemed secondary to the goal of investor protection:

However, our holding does not turn on Pearlstein's subjective knowledge of the law. In our view the danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission.¹²⁷

In this apparent turnabout, the Second Circuit began a return to that view of the Act which had earlier prompted its decision in *Baird*.¹²⁸

Judge Friendly, the author of the strict interpretation decision in *Colonial*, dissented. However, even he seemed to recognize that *Colonial* was not the answer to the troublesome issue of jurisdiction: "I recognize . . . that violations of these provisions may give rise to civil liability in appropriate cases, under any of several theories."¹²⁹ Judge Friendly did not advocate a repudiation of *Colonial's* substitution test, but he did appear to acknowledge the importance of *Buttrey's* focus on investor protection.¹³⁰ His disagreement with the majority stemmed, however, from his conclusion that section 7(c) was not enacted for investor protection purposes: "The economic purpose behind § 7(c) . . . causes the provision to differ from those portions of the securities acts more directly aimed at protection of investors."¹³¹ Nonetheless, this is far from his strict stance in *Colonial*.¹³²

¹²⁴ *Pearlstein v. Scudder & German*, 295 F. Supp. 1197, 1205 (S.D.N.Y. 1968).

¹²⁵ 429 F.2d at 1139.

¹²⁶ *Id.* at 1140.

¹²⁷ *Id.* at 1144.

¹²⁸ See text at notes 67-73 *supra*.

¹²⁹ 429 F.2d at 1147 (dissenting opinion). "But this is not an appropriate case." *Id.*

¹³⁰ See *id.* at 1148. "To be sure, it may be proper in some instances to impose civil liability in furtherance of the subsidiary purpose of § 7(c), protection of the innocent 'lamb'"

¹³¹ *Id.*

¹³² The Second Circuit in *Pearlstein* did not succeed in bridging the distance between itself and the Seventh Circuit. The Fifth Circuit recognized this in *Gordon v. DuPont Glore Forgan Inc.*, 487 F.2d 1260 (5th Cir. 1973), an action brought by investors against brokers for allegedly failing to notify plaintiffs that their account was undermargined. The court noted that the Seventh Circuit in *Buttrey* "has said that other stock exchange rules will support a private right of action," *id.* at 1262, and that the Second Circuit in *Pearlstein* "has held that a private cause of action exists under the

EXCHANGE RULE SUITS

In *Van Gemert*, the Second Circuit completed what it began in *Pearlstein*—an integration of its approach to securities act jurisdiction with that of the Supreme Court in *Borak*. Plaintiffs were holders of Boeing debentures purchased under an Indenture Agreement and listed on the New York Stock Exchange pursuant to a Listing Agreement between Boeing and the Exchange. The Listing Agreement was in accordance with the Exchange company manual,¹³³ and provided that the listed company would publish immediate notice of any action taken which would affect the rights of the holders of any of its securities, that the company would provide the holders sufficient time to exercise their rights with regard to the securities, and that the company would independently notify the Exchange of any such corporate action.¹³⁴ On February 28, 1966, Boeing decided to call its debentures.¹³⁵ In the subsequent news release the debenture call was not headlined in its own right, nor did the release contain the required tentative dates for redemption of the bonds and the expiration of the conversion rights.¹³⁶ Boeing's actions met the formal requirements of the Indenture, but not those of the Listing Agreement.¹³⁷

initial-purchase margin requirements set out in Regulation T," *id.* The court concluded that there was common ground between these two decisions, and that "the way is clear, we are told, to synthesize the two holdings and imply a right of action under the stock exchange rules setting margin maintenance standards." *Id.* However, here too the court was faced with the plaintiff's prior knowledge, and with "all due deference to the Second Circuit" held, narrowly, that non-innocent investors cannot recover for violations of stock exchange rules. *Id.* at 1263.

¹³³ On July 15, 1958 Boeing offered its shareholders the right to buy \$100 of convertible debentures for each 23 shares of stock owned. The debentures paid 4½% interest per annum, and were convertible at a rate of two shares for each \$100 of debentures. The Chase Manhattan Bank was appointed trustee. 520 F.2d at 1375. The 113-page Indenture Agreement, the Listing Agreement, the prospectus, and the registration statement for the debentures, as well as the debentures themselves, all provided for the potential redemption by Boeing of the debentures, and for notice of a redemption call. *Id.*

¹³⁴ "To insure coverage which will adequately inform the public, the news should be released to at least one or more newspapers of general circulation in New York City which regularly publish financial news, or to one or more of the national newswire services (Associated Press, United Press International), in addition to such other release as the company may elect to make."

Id. at 1376-77.

¹³⁵ Boeing released this news to the newspapers in a general article dealing with sales and net earnings of 1965, a possible stock increase, stock split, and post-split dividends. *Id.* at 1377.

¹³⁶ On March 2 Boeing fixed March 29, 1966 as the date for the expiration of the conversion privilege, with April 8 as the redemption date. It was not until March 7, 1966 that Boeing notified the Exchange of these pertinent dates. *Id.*

¹³⁷ It was not contested that the requirements of the Indenture were met by the Company. *Id.* at 1377. Boeing admitted that its publication failed to meet the standard demanded by the Listing Agreement, as defined by Section A10 of the Exchange "Company Manual": "Publicity: The term 'publicity' . . . as used in the listing agreement in respect of redemption action, refers to a general news release, and not to the formal notice or advertisement of redemption sometimes required by provisions of an indenture or charter Such news release shall be made as soon as possible after

The fifty-six named plaintiffs claimed that Boeing had failed to give adequate notice of the conversion call.¹³⁸ The gravamen of the complaint was that Boeing was civilly liable under federal law for violating exchange rules (contained in the Exchange Listing Agreement and Section A10 of the Company Manual) which were promulgated pursuant to section 6 of the Act.¹³⁹ The United States District Court for the Southern District of New York found that Boeing had complied with the notice provisions of the Indenture, and that even if Boeing had violated the Listing Agreement, this did not establish subject matter jurisdiction in the federal courts.¹⁴⁰

On appeal, the Second Circuit was thus once again confronted with the question whether the allegation of a breach of a stock exchange rule or regulation is a sufficient basis for jurisdiction under section 27. Mindful of the Seventh Circuit's decision in *Buttrey*, and its own recent decision in *Pearlstein*, the court was apparently ready to retreat from its strict holding in *Colonial*. The court held that Boeing had failed to give reasonable and adequate notice of the redemption to the debenture holders.¹⁴¹

The first question examined was whether there was jurisdiction to hear the suit. The analysis began with the statement that "[t]he Listing Agreement and Company Manual are 'instruments corresponding' to rules of the Exchange within Section 6(a)(3) of the Securities Exchange Act of 1934."¹⁴² After a brief inquiry into the historical perspectives of the jurisdictional question,¹⁴³ the court invoked *Borak* for the proposition that private litigants may bring both derivative and direct actions for breach of the 1934 Act and SEC rules.¹⁴⁴ The Second Circuit interpreted *Colonial* as having recognized that such suits were deemed to lie also for a breach of an exchange rule which was intended to directly protect investors.¹⁴⁵ Emphasis was placed on the

corporate action which will lead to, or which looks toward, redemption is taken . . . and shall be made by the fastest available means, i.e., telephone, telegraph or hand-delivery.'" *Id.* at 1376.

¹³⁸ *Id.* at 1379.

¹³⁹ *Id.* Jurisdiction was asserted under the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1970); the Securities Act of 1933, 15 U.S.C. § 77a (1970); the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa (1970); and principles of pendent jurisdiction, see 520 F.2d at 1382 n.19.

¹⁴⁰ It was also held that since appellants had failed to convert their debentures, they had no standing to raise the issue of an illegal conversion rate. 520 F.2d at 1375.

¹⁴¹ *Id.*

¹⁴² *Id.* at 1380.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* The court conceded that this was stated in dictum in *Colonial*. However, even this concession is a mischaracterization of *Colonial*, see text at notes 37-39 *supra*, and seems unrepresentative of the manner in which *Colonial* has been interpreted by other courts. See, e.g., *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F. Supp. 678, 682 (D. Wyo. 1975), where the reluctance of the *Colonial* court to enforce an "amorphous" standard which gave no guidelines to exchange members was noted; *Wells v. Blythe & Co., Inc.*, 351 F. Supp. 999, 1001 (N.D. Cal. 1972), where the heavy burden of persuasion put on plaintiffs by the *Colonial* test was emphasized.

EXCHANGE RULE SUITS

idea expressed in *Colonial* that "[a] particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement"¹⁴⁶ In *Colonial*, however, this had meant that the rule must in effect be a substitute for a Commission rule. In *Van Gemert*, the court used this same language from *Colonial* as a basis for holding that violations of exchange rules will always give a federal court jurisdiction.¹⁴⁷

It must be assumed that in so reinterpreting its earlier language from *Colonial*, the Second Circuit will now emphasize the practical effect of allowing such suits, particularly in terms of supplementing SEC regulation, and is no longer concerned with whether an exchange rule is technically a substitute for direct SEC action. *Buttrey* was mentioned briefly,¹⁴⁸ for the proposition that there is an implied private right of action based on exchange rules. Significantly, it was used to buttress the jurisdictional theory which the court "found" in *Colonial*. There is no mention in *Van Gemert*, however, of the actual differences in approach between *Colonial* and *Buttrey*.

Nonetheless, in thus balancing *Colonial* and *Buttrey*, the Second Circuit has implied that while it is willing to retreat from the strict interpretation approach of *Colonial*, it does not completely approve the free-wheeling position of *Buttrey*. The lack of definition as to jurisdictional requirements that is an infirmity in *Buttrey* is avoided while the standard of investor protection found therein is accepted. Thus, the *Van Gemert* court succinctly stated: "The claim for relief is sufficient for jurisdictional purposes in any event."¹⁴⁹ This statement suggests that the strict requirements of *Colonial* are now felt unnecessary and that a broader approach, indicated in *Borak* and *Buttrey*, is more appropriate.

Having found jurisdiction, the court then examined the question of whether there was a duty in favor of the plaintiffs which would serve as the basis of liability. The resemblance to *Borak* and *Buttrey* is evident in the manner in which the court examined the issues of duty and public liability. The court stressed the position that the Exchange occupies in relation to the investing public. Central to this relationship is the public trust in the Exchange, and the public knowledge that a member must meet certain standards. "[I]t is held out to the investing public that by dealing in securities listed on the New York Stock Ex-

¹⁴⁶ 520 F.2d at 1380.

¹⁴⁷ *Id.* at 1381. It is interesting to note that the result reached in *Colonial* is set forth in a footnote in *Van Gemert* (*id.* at n.14), wherein *Colonial* is listed along with other Second Circuit cases dealing generally with the question of federal civil liability, beginning with *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944). This effectively glosses over the differences that exist between *Colonial* on the one hand and *Baird*, and now *Van Gemert*, on the other.

¹⁴⁸ 520 F.2d at 1381.

¹⁴⁹ *Id.* at 1382. The desire for unanimity prompted the writer of the opinion, Judge Oakes, to join the majority, although he felt the result could be reached on a third-party beneficiary theory. *Id.* at 1328 n.19.

change the investor will be dealt with fairly and pursuant to law."¹⁵⁰ This approach is reminiscent of *Borak*;¹⁵¹ yet *Van Gemert* went one very important step beyond. In *Borak*, the Court concluded that the Act itself sets up a class to be protected and safeguards this class from certain harm.¹⁵² In *Van Gemert*, on the other hand, the rules promulgated by the exchanges were viewed as defining the duty of protection; that is, the rules extend or limit the duties created by the Act. Not all rules would raise a duty between the exchange and the public. For example, "housekeeping" rules,¹⁵³ intended merely to govern the relationship between exchange and member raise no public duties. Thus, each rule must still be examined to determine public liability.¹⁵⁴ This approach is markedly different from that in *Buttrey*, however, where the existence of a design for investor protection established both jurisdiction and potential public liability at once, leaving only the facts of injury and proximate causation to be decided when the merits of the case were reached.¹⁵⁵ Thus, while a plaintiff may still be dismissed should his suit allege violation of a rule determined to be of the housekeeping variety, the dismissal will not be for want of jurisdiction under *Van Gemert*, as it would have been under *Buttrey*. He will thus be given a greater opportunity to prove that a given rule is indeed designed for active investor protection.

Additionally, and more importantly, *Van Gemert* resolves the question left unanswered by *Buttrey*.¹⁵⁶ Under *Van Gemert*, the federal courts have exclusive jurisdiction of all suits alleging violations of stock exchange rules. The plaintiff no longer has the option of bringing these suits in a state court. This result buttresses the federal statutory scheme for the protection of securities investors, since it will ensure a uniform body of federal case law.¹⁵⁷

The effects of *Van Gemert* should be far-reaching. It was decided by the Second Circuit, which is preeminent in the securities regulation area. Thus it is probably the final word on a problem that has plagued the federal courts for several years: whether private parties have jurisdiction to bring suits alleging violations of stock exchange rules by member-firms. Moreover, the attention of the federal courts will now be focused on the question of liability for such violations. This is the area which remains unsettled after *Van Gemert*. It can be

¹⁵⁰ *Id.* at 1381.

¹⁵¹ Compare *id.* with *J.I. Case Co. v. Borak*, 377 U.S. 426, 431-32 (1964). See text at notes 79-89 *supra*.

¹⁵² 377 U.S. at 432.

¹⁵³ See Lowenfels, *supra* note 100, at 24-28; Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 967-68 (1966).

¹⁵⁴ See 520 F.2d at 1383-86.

¹⁵⁵ 410 F.2d at 143. See text at notes 90-107 *supra*.

¹⁵⁶ See text at note 110 *supra*.

¹⁵⁷ See the discussion of federal liability for violation of stock exchange rules in light of *Cort v. Ash*, 422 U.S. 66 (1975), in note 108 *supra*.

EXCHANGE RULE SUITS

dealt with only on a case-by-case basis, meeting violations of the various rules as they are alleged. Nonetheless, a fuller and fairer exposition can be expected under *Van Gemert*, because the question will not be muddled with the properly separate question of jurisdiction to hear a federal claim, nor will it be clouded by elements of state causes of action which might be joined with it in a state court. Finally, *Van Gemert* is the first circuit court decision to find liability for breach of a stock exchange rule running between a private party and a non-member, listed securities issuer. The knowledge that they may be held liable for damages should introduce a degree of caution into the actions of listed firms.

CONCLUSION

The issue of whether there should be federal jurisdiction for suits alleging a violation of stock exchange rules has troubled the courts for some time. Early attempts at a resolution resulted in the narrow *Colonial* approach based on a strict—near literal—interpretation of the 1934 Act. The later approach of *Buttrey* focused on the much broader question of investor protection. *Van Gemert* is the most recent solution. The approach taken adopts certain aspects of each of the earlier cases: from *Colonial*, the emphasis on jurisdiction and from *Buttrey*, the concern with investor protection. The clarity of *Van Gemert* is a welcome addition to the area of jurisdiction in securities regulation law.

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