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Securities Regulations -- Civil Liability Under Section 17(a) of the Securities Act and Rule 15c1-7 of the Exchange Act

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gress never contemplated pretrial removal,[36] but the dissent maintained that the President was concerned only about the criminal liability of the state court judges under the act[37] and that Senator Trumbull was replying to Johnson in reference only to this aspect of the statute. "The Senator did not say, as the majority would infer, that these sections could not be brought into play by the action of . . . sheriffs and policemen . . . *prior* to the court proceedings."[38]

Dissenting Judges Bell and Sobeloff would hold these cases removable under subsection 1443(1) if "they have been denied these rights by state officials prior to trial. . . ."[39]

Part of the reason for the wide divergence in the opinions can be traced to the long period of time in which the problems remained dormant because of the lack of appellate review and the futility of attempting to reach conclusions about century-old congressional mood or intent. There seems to be some merit to the argument of the dissenters that the Eighty-ninth Congress meant for the federal courts to re-examine their position in regard to removal when it passed the proviso for appellate review of an order to remand. Whether or not this be the case, the conflict in the circuit courts necessitates clear explanation of the *Rives* and *Powers* opinions by a modern Court.

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Securities Regulations—Civil Liability Under Section 17(a) of the Securities Act and Rule 15c1-7 of the Exchange Act

In the expanding area of securities regulations, the Securities Act of 1933[1] and the Securities Exchange Act of 1934,[2] together with the rules promulgated thereunder, have been used increasingly as bases for finding civil liability for violations thereof. While sections 11, 12(1), and 12(2)[3] of the Securities Act and sections

[36] 357 F.2d at 767.
[37] Section 2 of the original act of 1866, now 18 U.S.C. § 242 (1964), provided that any state official who "shall subject or cause to be subjected any inhabitant . . . to the deprivation of any right secured or protected by this act . . . shall be guilty of a misdemeanor."
[38] 357 F.2d at 783.
[39] *Id.* at 773.

[1] 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-77bb (1964).
[2] 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-78jj (1964).
[3] 48 Stat. 82, 84 (1933), as amended, 15 U.S.C. §§ 77k, 77*l* (1964).

9(e), 16(b), 18, and 29(b)[4] of the Exchange Act expressly provide for civil remedies, liabilities in civil actions have been implied under other sections and rules.[5]

A recent decision extended a civil remedy to yet another rule under the Exchange Act. In *Newkirk v. Hayden, Stone & Co.*[6] a federal district court allowed recovery of damages under section 17(a) of the Securities Act[7] and rule 15c1-7[8] promulgated under section 15(c)(1) of the Exchange Act.[9] Plaintiff, a school teacher, had transferred his life savings to an account with defendant brokerage house. McNutt, a salesman of defendant, was to trade the account intending to make short-swing profits for plaintiff.

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[4] 48 Stat. 889, 896, 897, 903 (1934), as amended, 15 U.S.C. §§ 78i, 78p, 78r, 78cc (1964).

[5] J. I. Case Co. v. Borak, 377 U.S. 426 (1964) (sections 14(a) and 27 of the Exchange Act); Goldenburg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959) (section 7 of the Exchange Act); Standard Fruit & S.S. Co. v. Midwest Stock Exch., 178 F. Supp. 669 (N.D. Ill. 1959) (section 12(f) of the Exchange Act); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949) (section 17(a) of the Securities Act); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949) (section 11(d)(2) of the Exchange Act and Rule 17a-5); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (section 10(b) of the Exchange Act and Rule 10b-5). For a full discussion of expressed and implied civil liabilities under the Securities Act, the Exchange Act, and the rules pursuant thereto, see also Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966).

[6] CCH FED. SEC. L. REP. ¶ 91,621. (S.D. Cal. Sept. 30, 1965).

[7] 48 Stat. 84-5 (1933), 15 U.S.C. § 77q (1964). Section 17(a) of the act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communications in interstate commerce or by the use of mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[8] C.F.R. § 240.15c1-7 (1964) Section (a) provides:

> The term "manipulative, deceptive, or other fraudulent device, or contrivance", as used in section 15(c) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

[9] 52 Stat. 1075 (1938), 15 U.S.C. § 78*o*(c)(1) (1964).

Plaintiff was not familiar with the sophisticated maneuvers used in a trading account; therefore, he relied heavily on McNutt to manage the account in plaintiff's best interests. McNutt effected numerous transactions in the account over a three-month period, generating 2,722.55 dollars in commissions and causing capital losses of 2,245.57 dollars. In view of the fact that the account when opened contained a net equity of 8,439.65 dollars, the court held such heavy trading to be excessive and awarded damages equal to the amount of commissions charged.

Rule 15c1-7 is violated only where the account is discretionary. In finding the plaintiff's account to be discretionary, the court did not restrict itself to the formality of requiring "prior written authorization" by the customer.[10] Instead, the court applied a more practical test by looking to the customer's naivete and the degree of reliance placed upon McNutt's advice. Such a position is in line with decisions rendered by the SEC.[11]

The court in the principal case appeared to have little difficulty in finding an abuse of discretion in the actions of the salesman. The court rested its holding on the unusually large amount of commissions generated, the total value of the transactions (158,000 dollars) that took place in the three-month period, and the proportion of the salesman's total commissions represented by this single account (seventeen per cent). This reasoning is consistent with holdings of the Commission in cases dealing with churning—excessive trading—of customers' accounts.[12]

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[10] N.Y. Stock Exch. Rule 408, CCH N.Y. STOCK EXCH. GUIDE ¶ 2408. A salesman has discretionary power over a customer's account where "the prior written authorization of the customer has been received." Where such authorization is given, a salesman may trade the account for the customer's benefit without receiving specific orders from the customer.

[11] The Commission in Norris & Hirshberg, Inc., 21 S.E.C. 865, 870 (1946), held that an account was discretionary when a broker-dealer could "dominate the choice of investment and the timing and frequency of transactions. . . ." In E. H. Rollins & Sons, Inc., 18 S.E.C. 347, 380 (1945), the Commission declared that in regard to discretionary accounts the significant determination involves the status between the broker-dealer and the customer. In Behel, Johnsen & Co., 26 S.E.C. 163, 168 (1947), no express discretionary power was conferred on the dealer; however, the Commission found the registrant guilty of churning accounts of its customers. The Commission pointed out that the registrant occupied a position of trust in respect to its customers and should have managed their accounts with their best interest as a guide.

[12] *E.g.*, Shearson, Hammill & Co., CCH FED. SEC. L. REP. ¶ 77,306 (1965); Reynolds & Co., 39 S.E.C. 902 (1960); Walter S. Grubbs, 28 S.E.C. 323 (1948).

Although the traditional remedies for violations of section 17(a) of the Securities Act and rule 15cl-7 have been administrative sanctions imposed by the SEC,[13] the court allowed recovery of damages. It is not entirely clear whether the court based civil liability on a violation of section 17(a) or rule 15cl-7 or both. The general fraud provisions of section 17(a) have been relied upon under somewhat different circumstances to attach civil liability.[14] At the same time, no cases have been reported prior to *Newkirk* in which rule 15cl-7 was premised as a basis for recovery of damages. Nevertheless, it is submitted that the provisions of rule 15cl-7 that specifically prohibit churning are more directly applicable than the general fraud provisions of section 17(a).[15]

Although there is no express provision for civil liability under rule 15cl-7, the decision implying such liability is in keeping with a trend begun in 1946 in *Kardon v. National Gypsum Co.*[16] There the court allowed recovery of damages for a violation of rule 10b-5.[17] The federal district court based its holding on two theories: (1) common-law tort liability as a result of violation of a statute,[18] and (2) the implication of the wording of section 29(b) of the Exchange Act.[19] The former has particular applicability in *Newkirk*. Traditionally, courts have allowed recovery of damages for injuries resulting from violations of statutory enactments.[20] A

[13] Reynolds & Co., 39 S.E.C. 902 (1960) (suspension of registrant and Reynolds & Co. from membership in the National Association of Securities Dealers for thirty days); Behel, Johnsen & Co., 26 S.E.C. 163 (1947) (revocation of registration of registrant and expulsion from membership in the National Association of Securities Dealers).

[14] *E.g.*, Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963). (Action to recover damages for fraudulent misstatements and omissions of material facts in connection with the sale of stock); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949).

[15] Compare sections quoted in notes 7 and 8 *supra.*

[16] 69 F. Supp. 512 (E.D. Pa. 1946).

[17] 17 C.F.R. 240.10b-5 (1964).

[18] Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

[19] *Id.* at 514. 48 Stat. 903 (1933), as amended, 15 U.S.C. 78cc(b) (1964).

[20] RESTATEMENT (SECOND), TORTS § 286, comment *d* (1965), discussing the situation where a criminal statute does not provide expressly for civil liability, states in part:

> [T]he court is free, in making its own judicial rules, to adopt and apply to the negligence action the standard of conduct provided by such a criminal enactment or regulation. . . . The decision to adopt the standard [of conduct] is purely a judicial one, for the court to make. . . . On the same basis, the court may adopt the standard of conduct laid down by an administrative regulation.

member of a class for whose protection a criminal statute or regulation was designed may sue for damages caused by a breach of such law.[21] The dominating purpose of the Exchange Act and the rules promulgated thereunder is to provide protection for investors.[22] Certainly, a customer whose account has been excessively traded falls within the class of persons to be protected by rule 15c1-7 and the violation of the rule by the salesman constitutes activity from which investors are protected.

Another premise upon which civil liability can be argued is found in the jurisdictional section of the Exchange Act.[23] That section states that the federal district courts "shall have exclusive jurisdiction . . . *of all suits in equity and actions at law brought to enforce any liability or duty* created by this title or the rules and regulations thereunder."[24] Such language would seem to imply that Congress had civil suits for damages in mind when this section was written.[25]

A final argument for civil liability was made by the court in *Newkirk*. Under section 15A(b)(4) of the Exchange Act, the SEC is empowered to bar a broker from membership in the National Association of Securities Dealers for violations of the Act.[26] It would seem that allowing recovery of damages in a private action would constitute a less drastic result and might be preferable in some situations.

The principal argument posed against the extension of civil liability is the maxim, *expressio unius est exclusio alterius, i.e.*, since Congress neglected to make express provisions for civil liability, it intended that there be none.[27] This doctrine was severely limited as a rule of construction in *SEC v. C. M. Joiner Leasing*

[21] *Id.* at § 286; Comment, 59 YALE L.J. 1120, 1134-35 (1950).

[22] 14 U. CHI. L. REV. 471, 474-75 (1947); Comment, 59 YALE L.J. 1120, 1133 (1950). The author of the former note suggests that

> each section of the several federal securities acts in which certain conduct is made unlawful, and in which no exclusive remedy is provided, might become the basis of civil actions of the type under discussion, provided the section is designed for the protection of investors.

14 U. CHI. L. REV. at 478.

[23] 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1964).

[24] 48 Stat. at 902-03; 15 U.S.C. at § 78aa. (Emphasis added.)

[25] Lowenfels, *supra* note 5, at 18-19.

[26] 52 Stat. 1070 (1938), 15 U.S.C. § 78*o*-3(b)(4) (1964).

[27] Comment, 59 YALE L.J. 1120, 1133 & n.68 (1950).

Corp.,[28] where the Court stated that the rule must be "subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose. . . ."[29] Since the dominating purpose of the Exchange Act is to protect investors,[30] and since section 28(a) of the act provides that remedies created by the act shall be in addition to those available in law or equity,[31] it would seem that *expressio unius est exclusio alterius* has little or no applicability to a construction of the Exchange Act.

The court in *Newkirk,* while allowing liability for damages in a civil action, left several questions open for later clarification. For example, to what extent does a heavy loss in an account influence the court in its finding of an abuse of discretion? It would seem that at least some attention should be directed toward the general market trend during the period, since a broker-dealer should not be made to bear the burden of errors of judgment. To hold otherwise would allow the court to take advantage of hindsight in second-guessing the broker-dealer. At the same time, should the court take notice of the caliber of securities traded in a discretionary account? If so, then possibly the measure of damages should go beyond the commissions earned when it is shown that the particular securities traded were highly speculative and of doubtful value. Assuming commissions earned to be the correct measure of damages, would a recovery be allowed where an account, shown to have been excessively traded, has yielded a net *profit*? Although a case involving such a situation would be unlikely to arise, it must be remembered that the commissions charged still represent a reduction in the equity of the account. Where a reckless and willful disregard for the customer's interests is displayed by a broker-dealer while churning an account, should the court allow a recovery of punitive damages?[32] While the decision in *Newkirk* seems to be in line with the prevailing trend of the courts, the traditional application of tort liability for statutory violations, and the dominating purpose of the Exchange Act, it is evident that further decisions will be necessary

[28] 320 U.S. 344 (1943).
[29] *Id.* at 350.
[30] See note 22 *supra.*
[31] 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78bb (1964).
[32] An award of punitive damages would be highly unlikely since § 28 of the Exchange Act expressly prohibits a recovery under the act in excess of actual damages sustained. 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78bb(a) (1964).

to delineate the scope of and grounds for civil liability under rule 15c1-7.

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Taxation—Charitable Deductions—Bequest for Benefit of Employees

The majority shareholder of a corporation made a bequest of forty per cent of his residuary estate to a testamentary trust to provide pension payments to the employees of the corporation. Employees employed prior to, or at the time of, decedent's death who retired after twenty-five years of service were to receive monthly pension payments of not more than 125 dollars.[1] Yearly trust income in excess of that needed for pension payments was to be paid over to an employees' trust fund created by the corporation in 1946 for pension purposes. Upon the death of the last surviving employee-beneficiary, the trustees of the testamentary trust were to terminate it by paying 2,000 dollars to each of three named hospitals and the remainder of the income and corpus to the employees' trust fund. If the employees' trust fund was not in existence, the income and corpus was to be divided equally among the three hospitals.

After the Commissioner of Internal Revenue refused to allow the decedent's bequest to the trust as a charitable deduction, the decedent's estate paid the asserted estate tax deficiency and sued in a federal district court for a refund. The district court,[2] relying on an earlier Third Circuit decision,[3] held that the bequest was charitable and qualified for a deduction under section 812(d) of the 1939 Internal Revenue Code (the predecessor of section 2055 of the Internal Revenue Code of 1954). The court found that sufficient public benefit flowed from the trusts to make them charitable, the beneficiaries of the trusts were ascertainable, and the discretion vested in the trustees was limited to disbursements for charitable purposes. On appeal, in *Watson v. United States*[4] a divided Third Circuit reversed and held that the testamentary trust was not charitable. The majority of the court found that the trust benefited the

[1] The exact amount was to be determined by subtracting from $125 the amount of Social Security benefits and corporate pension payments received by an employee. Corporate officers and directors were not to receive pension payments.

[2] Watson v. United States, 63-2 U.S. Tax Cas. 90, 379 (D.N.J. 1963).

[3] Gimbel v. Comm'r, 54 F.2d 780 (3d Cir. 1931).

[4] 355 F.2d 269 (3d Cir. 1965).