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Cover Page Footnote

J.D. Candidate, 2006, Fordham University School of Law. My thanks go to my mentors, Jonathan Urestsky, Esq., and Michael Schwartzberg, Esq., for their inspiration and to Professor and Executive Vice President of the National Association of Securities Dealers, Inc ("NASD"), George Friedman, for his assistance. Special thanks go to my daughter, Leah , for being adorable and to my loving and dedicated wife, Ronit, for her love and support.

SEE NO EVIL, HEAR NO EVIL, DON'T GET SUED: SHOULD A PRIVATE CAUSE OF ACTION EXIST FOR A VIOLATION OF NASD CONDUCT RULE 3010?

*Amnon Wenger**

“The success of our securities markets is based on the high level of public confidence inspired by a strong system of investor protection, and on the entrepreneurial and innovative efforts of securities firms.”¹

“Paying attention to little things that most men neglect makes a few men rich.”²

The success of our securities markets depends on public confidence in those markets.³ There are many rules and regulations imposed on those in the securities industry to help protect investor confidence.⁴ Among those rules is the National Association of Securities Dealers, Inc. (“NASD”) Rule of Conduct 3010.⁵ Failure to follow the supervisory rules can cause one to

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1. *Concerning Financial Modernization Legislation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. 165 (1999) [hereinafter *Financial Modernization Legislation*] (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission).

2. Übersite—Famous Quotes, <http://www.ubersite.com/m/12589> (last visited Mar. 28, 2005).

3. See *Financial Modernization Legislation*, *supra* note 1, at 165 (statement of Arthur Levitt).

4. Anthony J. Badger, *The New Deal: The Depression Years, 1933-1940*, at 98 (1989) (noting that among the reasons for the passage of the securities acts was the perception that “[i]t was . . . essential to restore [investor] confidence that had been badly shaken in . . . the marketing of investment securities”). For rules that protect investor confidence, see Securities Act of 1933, 15 U.S.C. § 77 (2000), and Exchange Act of 1934, 15 U.S.C. § 78 (2000). For specific NASD rules that protect investors, see NASD, Inc., Rules of Conduct 2000-3520 (2005).

5. NASD, Inc., Rule of Conduct 3010. The Rule states, in applicable part, that “[e]ach member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member.” *Id.* § 3010(a). The remainder of the Rule details the minimum requirements for a supervisory system, as well as

reach the opposite result of Henry Ford's statement above:⁶ When the rich men, or broker-dealers, neglect the little things (such as failing to supervise), many men may go broke.⁷ This Note explores the laws surrounding broker-dealers' liability in relation to their obligation to supervise the actions of their brokers.⁸ Part I of this Note traces the judiciary's historical attitude toward implying or denying private causes of action, specifically in relation to violations of NASD rules.⁹ It also details the rampant industry practice of permitting these claims and the apparent Securities and Exchange Commission ("SEC") approval, or at least acknowledgement, of this trend in arbitrations.¹⁰ Part II.A presents the court decisions and policy arguments for not implying this private cause of action,¹¹ while Part II.B, by contrast, focuses on cases and reasons in support of implying a private cause of action for violating the SEC's supervisory rules. Finally, Part III proposes a direction that the law should take and explains how best to implement a policy that removes the doubt and uncertainty from the current securities laws. Part III also speculates as to the future direction of law in this area.

I. IMPLYING PRIVATE CAUSES OF ACTION: A HISTORICAL PERSPECTIVE

Some background information is necessary to understand the issues surrounding private causes of action with respect to securities. This part presents an overview of the history of investor protections and private remedies in securities law.¹² This part also looks at the difficulties faced by courts deciding when and how to imply private causes of action.¹³ Finally, this part details the impact that arbitration policies and recent legislation have had on the use of private causes of action for violations of the SEC supervisory rules.¹⁴

the written procedures, internal inspections, and review of transactions necessary to the upkeep of a supervisory system. *See id.*

6. *See* Übersite—Famous Quotes, <http://www.ubersite.com/m/12589> (last visited Mar. 28, 2005).

7. It is axiomatic that if the securities industry saw fit to promulgate supervisory rules following both the crash of 1929 and then again following the Enron collapse, the industry did so in part to counter the perception that lack of supervision either contributed to, or could in some way have further aggravated, those economic disasters. *See generally* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. Rich. L. Rev. 317 (2004). "Sarbanes-Oxley arose out of this failure to impose meaningful standards in the area of corporate governance . . ." *Id.* at 320.

8. The term "broker-dealer" as used in this Note refers to the brokerage firm or supervisors, whereas the term "broker" refers to the individual broker.

9. *See infra* Part I. There is no explicit statutory basis for allowing a private cause of action for violations of the NASD supervisory rule. Traditionally, a court will imply a private cause of action, though no explicit statutory action exists, when it is implicit from either the text or congressional intent. *See infra* Part I.

10. *See infra* Part I.B.5.

11. *See infra* Part II.A.

12. *See infra* Part I.A.

13. *See infra* Part I.B.1-4.

14. *See infra* Part I.B.5-6.

A. Overview

The stock market crash of 1929 “prompted calls for reform.”¹⁵ Among the numerous reforms was the creation of the SEC.¹⁶ Congress established the SEC in 1934 to “regulate the commerce in stocks, bonds, and other securities.”¹⁷ During the post-crash Depression it was believed that lack of regulation had allowed the perpetuation of fraud and thus contributed to the crash.¹⁸ In response, Congress passed the Securities Act of 1933 (“Securities Act” or “1933 Act”), which “required public corporations to register their stock sales and distribution and make regular financial disclosures”¹⁹ and “[t]he Securities Exchange Act of 1934 [which] created the SEC to regulate exchanges, brokers, and over-the-counter markets, as well as to monitor the required financial disclosures.”²⁰

With the new rules came new questions of liability. Once there was a body of law in place making certain types of conduct illegal, the question of who was liable remained.²¹ Although a broker who violated the law was liable to his clients, investors wished to sue the deeper pockets of the brokerage firms that employed the culpable broker.²² Harmed investors, therefore, sought out legal theories that would enable them to recover from the brokerage firms.

There are many theories of liability that have been applied to hold broker-dealers liable for the tortious or improper conduct of their employees. These theories of liability include controlling person liability, aiding and abetting, respondeat superior, and failure to supervise.²³ “The question where that responsibility for supervision, and the liability for failing to do so, begins and ends [is] subject to debate.”²⁴ This Note addresses that debate.

The 1933 Act and the Securities Exchange Act of 1934 (“Exchange Act” or “1934 Act”) do not explicitly authorize a private²⁵ cause of action for a

15. The Society of American Historians, *The Reader’s Companion to American History* 976 (1991), available at http://college.hmco.com/history/readerscomp/rcah/html/ah_077800_securitiesan.htm [hereinafter Society].

16. Cabell Phillips, *From the Crash to the Blitz 1929-1939*, at 140 (2000).

17. Society, *supra* note 15, at 976.

18. *Id.* But see James F. Willis & Martin L. Primack, *An Economic History of the United States 359-72* (2d ed. 1989) (detailing other possible causes of the Great Depression).

19. Society, *supra* note 15, at 976.

20. *Id.*

21. See David L. Ratner & Thomas Lee Hazen, *Securities Regulation: Cases and Materials* 947 (4th ed. 1991).

22. See, e.g., *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980); *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980).

23. Dexter Johnson, *Staying Out of Trouble with the SEC: Tips for the Brokerage Firm*, The LawHost Online, Fall 1998, <http://www.lawhost.com/lawjournal/98fall/tips.html>.

24. *Id.*

25. The term “private” does not “encompass enforcement actions by governmental agencies or officers acting in the interest of whatever classes of the general public the statute may be interpreted to have been designed to protect.” Charles C. Marvel, *Implication of*

violation of NASD rules.²⁶ The aforementioned causes of action may not always be available depending on the jurisdiction²⁷ or circumstances involved.²⁸ It would be convenient for those suing to be able to point to an independent cause of action that arises from the brokerage firm's failure to supervise its employees, thus eliminating the need to rely on blue-sky laws,²⁹ respondeat superior, negligence and other similar theories. NASD Conduct Rule 3010 details the supervisory requirements imposed upon member firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [the rules of the NASD]."³⁰ Thus, plaintiffs routinely implore the courts to imply a private cause of action for violations of NASD Conduct Rule 3010.³¹ The courts have attempted to reconcile plaintiffs' requests with congressional intent.³²

B. Case Law: The Courts Tackle Implying Private Remedies

The various securities acts are "the principal governors of federal securities law regulation."³³ Congress, when creating these guidelines, also created a means of enforcement.³⁴ In some instances, Congress allowed for its disciplinary body, the SEC, to have sole power to punish violators.³⁵ In

Private Right of Action from Provision of Federal Statute Not Expressly Providing for One—Supreme Court Cases, 61 L. Ed. 2d 910, 912-13 n.1 (2004).

26. Securities Act of 1933, 15 U.S.C. § 7 (2000); Exchange Act of 1934, 15 U.S.C. § 78 (2000).

27. See, e.g., *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978) (stating that respondeat superior is precluded following the advent of controlling-person liability). But see *SEC v. Mgmt. Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975) (holding that controlling-person liability was meant to "expand, rather than restrict, the scope of liability"). For an excellent discussion of whether blue-sky laws are precluded, see David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 Bus. Law. 1, 14 (1998).

28. For example, controlling-person liability contains a good faith exception. See *infra* notes 321-22 and accompanying text.

29. Blue-sky laws are specialized state statutes that, between 1911 and 1933, were almost exclusively responsible for the regulation of securities sales in the United States. Stefania A. Di Trolio, *Corporate Governance and the Sarbanes-Oxley Act: Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 Wm. Mitchell L. Rev. 1279, 1283 (2004). "State blue-sky laws were a response by the state legislatures to securities fraud and other serious abuses in unregulated markets." *Id.* Blue-sky laws still play an important role in enforcing securities regulation. *Id.* at 1314.

30. NASD, Inc., Rule of Conduct 3010 (2005).

31. Almost 6000 failure to supervise claims were brought in 2003 and 2004. NASD, NASD Statistics, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12 (last visited July 1, 2005) [hereinafter Statistics].

32. See *infra* Part I.B.

33. Marc L. Steinberg, *Securities Regulation* 1 (4th ed. 2004).

34. The Securities and Exchange Commission ("SEC") has the power to both administer and enforce securities law. *Id.*

35. David L. Ratner, *Securities Regulation: In a Nutshell* 240-50 (6th ed. 1998). "The 1964 Securities Acts Amendments gave the Commission direct power to suspend or bar

other instances, Congress expressly created a private cause of action, allowing individuals to sue for damages, in addition to the penalties imposed by the SEC.³⁶ The controversy arises in those situations—such as failure to supervise—when there is no express private cause of action.³⁷ Did Congress really mean to deny the investor all means of recovery? Did Congress merely intend to limit all means of recovery through litigation, while allowing for the possibility of recovery through other avenues such as arbitration? Or, although not explicitly mentioned, was Congress's intent that private causes of action should be implied into the text of the Act? The courts have grappled with these questions for quite some time.³⁸

The history of implied private action remedies can be broken down into two parts. First, there is the case law on the subject which can further be broken down into two main eras: pre-1977 and post-1977.³⁹ Second, in part due to the bulwark of securities cases bypassing the court system for arbitration, there is the industry practice that has emerged separate from the court system which allowed customers to bring failure to supervise claims.⁴⁰

1. Traditional Views: Dispute Among the Circuits

Prior to the mid-1970s the courts were split on whether a private cause of action could be implied for a violation of NASD rules.⁴¹ Some courts had said that in order to create a right of action there must be legislative intent to create such a right.⁴²

In *Colonial Realty Corp. v. Bache & Co.*, Judge Henry J. Friendly recognized that there could be no blanket rule covering all violations of New York Stock Exchange and NASD rules.⁴³ Instead, Judge Friendly held as follows:

from association with any broker-dealer any person who the Commission finds has violated . . . the 1934 Act." *Id.* at 241. Additionally, "[i]n 1990, Congress significantly expanded the SEC's powers by giving it authority (a) to impose civil penalties . . . and/or order disgorgement . . . and (b) to issue cease and desist orders." *Id.*; see also *infra* notes 132-37 and accompanying text (discussing the Maloney Act and the NASD's jurisdictional authority).

36. See, e.g., 15 U.S.C. § 77t (2000) (creating a private remedy for controlling-person liability).

37. See *infra* Part I.B.1-4.

38. See, e.g., *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Reddington*, 442 U.S. 560 (1979); *Cort v. Ash*, 422 U.S. 66 (1975); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966); *Starkman v. Seroussi*, 377 F. Supp. 518 (S.D.N.Y. 1974). For an in-depth discussion of these cases, see *infra* Part I.B.1-3.

39. Compare *infra* Part I.B.1, with *infra* Part I.B.2-4.

40. See *infra* Part I.B.5.

41. See *infra* notes 46-51 and accompanying text.

42. See *Colonial Realty*, 358 F.2d at 182 (explaining that courts must look at the nature of the rule in relation to the regulatory scheme to determine if a remedy should be implied).

43. *Id.*

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.⁴⁴

Other courts allowed the implication provided that the rule was intended to protect investors.⁴⁵ In *Buttrey v. Merrill Lynch*, the court found that even if an exchange or self-regulatory organization ("SRO") rule had two functions—a "non-actionable 'housekeeping' function" and a "public protection function"—a violation of the rule would be actionable under the "public protection function."⁴⁶ The U.S. Court of Appeals for the Seventh Circuit, quoting the U.S. Supreme Court's ruling in *J.I. Case Co. v. Borak*,⁴⁷ said that "[p]rivate enforcement . . . provides a necessary supplement to Commission action. . . . [T]he possibility of civil damages . . . serves as a most effective weapon."⁴⁸ In the mid-1970s, the Supreme Court stepped in to settle the debate.⁴⁹

2. Courts Begin Restricting Private Remedies

In 1975, the Supreme Court recognized, in limited form, that private rights of action with respect to securities laws could be implied.⁵⁰ In *Cort v. Ash*,⁵¹ the Court detailed the criteria needed to imply a private cause of action.⁵² The Court stated that "[i]n determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant."⁵³ First, a court should determine whether "the plaintiff [is] 'one

44. *Id.*

45. Eunice A. Eichelberger, Annotation, *Private Federal Right of Action Against Brokerage Firm for Violation of Exchange or Dealer Association Rule*, 54 A.L.R. Fed. 11 (1981) (updated April 2002); see, e.g., *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141-43 (7th Cir. 1969) (holding that enactment of New York Stock Exchange Rule 405 may have been for the protection of investors); *Starkman v. Seroussi*, 377 F. Supp. 518, 523 (S.D.N.Y. 1974) (holding that New York Stock Exchange Rule 405 "is aimed at protecting the customer from being drawn into questionable transactions or speculative activities far beyond his purse," and therefore allowing implication); cf. *Carras v. Burns*, 516 F.2d 251, 260 (4th Cir. 1975) (finding that since margin maintenance requirements "were not promulgated for the protection of investors, they create no cause of action").

46. *Buttrey*, 410 F.2d at 141.

47. 377 U.S. 426, 432 (1964).

48. *Buttrey*, 410 F.2d at 142 (quoting *Borak*, 377 U.S. at 432).

49. See *infra* notes 53-76 and accompanying text.

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

51. *Id.*

52. *Id.* at 78.

53. *Id.* It should be pointed out here that *Cort*, and the two subsequent cases, *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), and *Touche Ross & Co.*

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."⁵⁴ Next, courts should ask if there is "any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one."⁵⁵ The third factor is whether implying the cause of action is "consistent with the underlying purposes of the legislative scheme."⁵⁶ Lastly, courts should consider whether the cause of action is "one traditionally relegated to state law," making it "inappropriate" to imply a federal cause of action.⁵⁷ The Court noted, however, that the "provision of a criminal penalty does not necessarily preclude implication of a private cause of action for damages."⁵⁸

The validity of the *Cort* test soon came under criticism. In two 1979 cases, the Supreme Court reanalyzed the standard for implying private actions. In *Transamerica Mortgage Advisors, Inc. v. Lewis*,⁵⁹ the Court answered the question of whether the Investment Advisors Act of 1940⁶⁰ created "a private cause of action for damages or other relief in favor of persons aggrieved by those who allegedly have violated it."⁶¹ The Court first recognized that there is no explicit cause of action created by the Act, but rather the Act only expressly permits the SEC to bring suit to enjoin violations.⁶² The plaintiffs argued that "clients of investment advisers were the intended beneficiaries of the Act and that courts should therefore imply a private cause of action in their favor."⁶³ Rather than run the Investment Advisors Act through the four-factor test enumerated in *Cort*, the Court dismissed that test and focused strictly on congressional intent.⁶⁴ Interestingly, the Court did not deem silence in the legislative history fatal to proving intent, as such intent may "appear implicitly in the language or structure of the statute, or in the circumstances of its enactment."⁶⁵ However, the Court was persuaded that where a statute expressly provides

v. Redington, 442 U.S. 560 (1979), all relate to implying private causes of action directly from the statute. My discussion, implying private causes of action for violations due to failure to supervise, has no direct statutory basis, but, rather, is implied from a violation of self-regulatory organization ("SRO") rules. For a more in-depth discussion of this process, see *infra* notes 78-94 and accompanying text.

54. *Cort*, 422 U.S. at 78 (quoting *Texas & Pac. R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916) (emphasis omitted)).

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.* at 79 (emphasis omitted).

59. 444 U.S. 11 (1979).

60. Investment Advisors Act of 1940, 15 U.S.C. § 80b-1 (2000).

61. *Transamerica*, 444 U.S. at 13.

62. *Id.* at 14.

63. *Id.*

64. *Id.* at 15-16 ("While some opinions of the Court have placed considerable emphasis upon the desirability of implying private rights of action in order to provide remedies thought to effectuate the purpose[] . . . what must ultimately be determined is whether Congress intended to create the private remedy asserted.").

65. *Id.* at 18.

for a remedy, a court should not read others into it.⁶⁶ "The mere fact that [a] statute was designed to protect advisers' clients does not require the implication of a private cause of action for damages on their behalf."⁶⁷

Similarly, in *Touche Ross & Co. v. Redington*,⁶⁸ the Court held that customers of securities brokerage firms did not have an implied private cause of action under section 17(a) of the Securities Exchange Act of 1934.⁶⁹ The Court recognized that the "existence of a statutory cause of action is . . . one of statutory construction."⁷⁰ The Court agreed with the *Cort* decision in that "the fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person."⁷¹ In a departure from the four-factor test of *Cort*, the *Touche Ross* Court found that "our task is limited solely to determining whether Congress intended to create the private right of action asserted."⁷² The Court further recognized, in regard to section 17(a), that "the legislative history of the 1934 Act is entirely silent on the question whether a private right of action for damages should or should not be available."⁷³ The Court also acknowledged the dangers inherent in implying causes of action from silence: "[I]mplying a private right of action on the basis of congressional silence is a hazardous enterprise, at best."⁷⁴ The Ninth Circuit later applied this principle to the specific question of implying private remedies for a violation of a NASD rule.⁷⁵

3. *Jablon v. Dean Witter & Co.*:⁷⁶ Applying *Transamerica* and *Touche Ross* to NASD Rule Violations

In 1980, shortly after the *Transamerica* and *Touche Ross* decisions, the Ninth Circuit specifically extended the logic upon which those cases were based to the realm of New York Stock Exchange rules and NASD rules.⁷⁷ In *Jablon v. Dean Witter & Co.*, the court questioned whether a private

66. *Id.* at 19.

67. *Id.* at 24.

68. 442 U.S. 560 (1979).

69. *Id.* Section 17(a) of the Securities Exchange Act of 1934 details the record-keeping and reporting obligations imposed on any "national securities exchange, member thereof, broker or dealer who transacts a business in securities through the medium of any such member, registered securities association, registered broker or dealer, registered municipal securities dealer, registered securities information processor, registered transfer agent, and registered clearing agency and the Municipal Securities Rulemaking Board." 15 U.S.C. § 78q(a) (2000).

70. *Touche Ross*, 442 U.S. at 568. As an interesting answer to proponents of implying private rights of actions based on tort principles, the Court held that the argument "in favor of implication of a private right of action based on tort principles . . . is entirely misplaced." *Id.*

71. *Id.* at 567 (quoting *Cannon v. Univ. of Chicago*, 441 U.S. 677, 688 (1979)).

72. *Id.*

73. *Id.* at 571.

74. *Id.*

75. See *infra* notes 78-94 and accompanying text.

76. 614 F.2d 677 (9th Cir. 1980).

77. *Id.*

cause of action existed for violations of New York Stock Exchange and NASD rules,⁷⁸ noting that the Supreme Court rulings “reflect[ed] a restrictive approach to implying private rights of action.”⁷⁹ The court held that, “[a]lthough those cases involved statutes rather than stock exchange [or NASD] rules, we think the same approach should apply in this case.”⁸⁰ The test that the Ninth Circuit used is actually stricter than that utilized by the Supreme Court. The Ninth Circuit held as follows:

Because the stock exchange rules were not enacted by Congress but by the exchange acting on authority delegated by Congress, a two-step inquiry is necessary: (1) whether Congress intended to delegate authority to establish rules implying a private right of action; (2) whether the stock exchange rules were drafted such that a private action may legitimately be implied.⁸¹

The Ninth Circuit never reached the question of whether New York Stock Exchange or NASD rules were legitimately implied, instead hamstringing the entire argument by holding “that Congress did not intend to create private rights of action for violation of stock exchange rules.”⁸² Instead, the *Jablon* court analyzed the New York Stock Exchange question and the NASD question separately.⁸³ With regard to the New York Stock Exchange rules, the Ninth Circuit held that the “Securities Exchange Act does not expressly authorize private actions for stock exchange rule violations.”⁸⁴ After reviewing the reasons traditionally listed for implying a private cause of action, the court concluded that in light of the recent “restrictive approach to implying private rights of action,” those reasons are no longer valid.⁸⁵

The Ninth Circuit then turned to the NASD Rules. The court first ruled out any possible interpretation that the right could be explicit.⁸⁶ The petitioner argued that “a private right is implicit because § 15A(b)(6) of the Securities Exchange Act, requiring a stock association to adopt disciplinary rules, establishes an actionable duty under § 27.”⁸⁷ The Ninth

78. The specific rules allegedly violated in *Jablon* were the New York Stock Exchange “know your customer” rule, the NASD “suitability” rule, and SEC Rule 10b-5. *Id.* at 678.

79. *Id.* at 679.

80. *Id.*

81. *Id.*

82. *Id.* Because the court held that the suit failed the initial prong, it never reached the second prong of the test for determining whether the SEC intended to create a private action. *Cf. id.*

83. *Id.*

84. *Id.*

85. *Id.* After establishing that the only determinative factor is congressional intent, the court found that a private cause of action could not be implied “[b]ecause we find no congressional intent to provide a private action for violation of stock exchange rules.” *Id.* at 681.

86. *Id.*

87. *Id.* (citation omitted). Section 27 of the Securities Exchange Act of 1934 is a catchall provision granting the “district courts . . . exclusive jurisdiction of violations of . . . the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by” the securities acts. 15 U.S.C. § 78aa (2000).

Circuit, relying on the Supreme Court, held that an implied private action cannot be based on section 27.⁸⁸ It also held that section 15A(b)(6) does not “in itself imply that Congress intended to create a private action. Its language, like that of sections 6(b)⁸⁹ and 17(a)⁹⁰ of the Securities Exchange Act, ‘neither confers rights on private parties nor proscribes any conduct as unlawful.’”⁹¹ Additionally, the court found it compelling that no explicit cause of action was given, especially when other parts of the Exchange Act specifically provide as such.⁹²

The last bastion of implied private remedies in securities litigation remained in cases involving fraud, where courts consistently implied private causes of action through SEC Rule 10b-5,⁹³ the implementing rule under the general antifraud provision of Exchange Act section 10(b).⁹⁴ Courts and commentators postulated the following:

Although it has been contended that Congress intended to confine any enforcement of benefits secured to private parties to actions by the SEC by way of injunction or criminal prosecution, on the grounds of the existence of the express civil liability clauses of the Exchange Act, such a contention has been uniformly rejected, and there now can be no doubt as to the existence of civil liability [with respect to Rule 10b-5].⁹⁵

It was through Rule 10b-5 that the concept of implying private causes of action had remained a viable pleading in cases.⁹⁶ But even with Rule 10b-

88. *Jablon*, 614 F.2d at 680.

89. The Securities Exchange Act of 1934, section 6(b), establishes the registration requirements for a securities exchanges and their members. 15 U.S.C. § 78f.

90. *See id.*

91. *Jablon*, 614 F.2d at 681 (quoting *Touche Ross v. Reddington*, 442 U.S. 560, 569 (1979)).

92. *Id.*

Our conclusion that neither § 6(b) nor § 15A(b)(6) provides private rights of action is further supported by the fact that sections 9(e), 16(b), and 18 of the Securities Exchange Act explicitly provide private rights of action. The Supreme Court found no implied private action under § 17(a) of the Act because “when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly.”

Id. (quoting *Touche Ross*, 442 U.S. at 572). The court went even further, stating, “We believe . . . it highly improbable that Congress absentmindedly forgot to mention an intended private action in either § 6(b) or § 15A(b)(6).” *Id.* (internal quotations omitted).

93. 17 C.F.R. § 240.10b-5 (2004). “Rule 10b-5 is the leading anti-fraud weapon in the federal securities laws.” Donna M. Nagy et al., *Securities Litigation and Enforcement* 19 (2003). Rule 10b-5 covers material misstatements and omissions. *Id.* Most of the recent highly publicized accounting scandals at WorldCom, Xerox, Enron, and others have involved Rule 10b-5 infractions. *Id.* at 24.

94. *See* 69A Am. Jur. 2d *Securities Regulation—Federal* § 935 (1993). Rule 10b-5 makes it unlawful to “employ any device, scheme, or artifice to defraud.” 17 C.F.R. § 240.10b-5(a) (2004).

95. *Securities Regulation—Federal*, *supra* note 94, § 935 (citing *Gilbert v. Nixon*, 429 F.2d 348 (10th Cir. 1970); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968)).

96. *Id.* Interestingly, neither the drafter of Rule 10b-5, Milton Freeman, nor the SEC, envisioned creating an implied private right of action under Rule 10b-5. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975); William T. Allen & Reiner Kraakman, *Commentaries and Cases on the Law of Business Organization* 590 (2003).

5, where there “can be no doubt,”⁹⁷ the Supreme Court curtailed the expansive application of this right in the landmark case of *Central Bank of Denver v. First Interstate Bank of Denver*.⁹⁸

4. Courts Embrace Complete Textualism

In *Central Bank*, the Court struck a blow to proponents of implying private causes of action.⁹⁹ The question in *Central Bank* was “whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation.”¹⁰⁰ The Court noted that in the past it had only allowed implied causes of action for certain provisions of the Exchange Act, specifically “by the terms of §§ 10(b) and 14(a) of the 1934 Act.”¹⁰¹ Touting the same argument, that if Congress intended to create a private cause of action it would have done so explicitly, the Court declined to imply a private cause of action.¹⁰² In stark language the Court chided, “Congress knew how to impose aiding and abetting liability when it chose to do so.”¹⁰³ The Court continued, “[i]f, as respondents seem to say, Congress intended to impose

Milton Freeman famously recounted the hurried events leading to the promulgation of Rule 10b-5:

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the director of the Trading and Exchange Division. He said, “I have just been on the telephone with Paul Rowen,” who was then the S.E.C. Regional Administrator in Boston, “and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for the coming year. Is there anything we can do about it?” So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where “in connection with the purchase or sale” should be, and we decided it should be at the end.

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

Blue Chip Stamps, 421 U.S. at 767 (citing *Conference on Codification of the Federal Securities Law*, 22 Bus. Law. 793, 922 (1967)).

97. *Securities Regulation—Federal*, *supra* note 94, § 935 (citing *Gilbert*, 429 F.2d at 348; *Heit*, 402 F.2d at 909).

98. 511 U.S. 164, 167 (1994).

99. *Id.* at 185.

100. *Id.*

101. *Id.* at 171 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971)); *J. I. Case Co. v. Borak*, 377 U.S. 426, 430-35 (1964).

102. *Central Bank of Denver*, 511 U.S. at 185, 192-93.

103. *Id.* at 176-77 (citations omitted).

aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not."¹⁰⁴

More recently, the Court has again come down on the side of restricting implied private causes of action. In *Alexander v. Sandoval*,¹⁰⁵ the Court held as follows:

Like substantive federal law itself, private rights of action to enforce federal law must be created by Congress. The judicial task is to interpret the statute that Congress has passed to determine whether it displays an intent to create not just a private right but also a private remedy. . . . Without [such intent], a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute. . . .

....

. . . In determining whether statutes create private rights of action . . . legal context matters only to [the] extent it clarifies text. . . . Statutes that focus on the person regulated rather than the individuals protected create "no implication of an intent to confer rights on a particular class of persons."¹⁰⁶

The Court defined the class used in determining whether a federal right of action existed even more narrowly in *Gonzaga University v. Doe*.¹⁰⁷ The Court determined that "where a statute does not include this sort of explicit 'right- or duty-creating language' . . . [the Court] rarely impute[s] to Congress intent to create a private right of action."¹⁰⁸

Despite consistent precedent limiting and disallowing private rights of action in litigation, the law remains unsettled because plaintiffs have consistently chosen to seek redress through arbitration.¹⁰⁹

5. Arbitrating Failure to Supervise Claims: How Arbitration Differs from Litigation

As courts have restricted the ability of harmed investors to seek redress through litigation, these investors increasingly have turned to arbitration.¹¹⁰ This avenue has not always been available for claims based on the 1933 and 1934 Acts.¹¹¹ In *Wilko v. Swan*,¹¹² the Supreme Court held that arbitration

104. *Id.* (internal citations omitted); *Pinter v. Dahl*, 486 U.S. 622, 650 (1988) ("When Congress wished to create such liability, it had little trouble doing so."); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) ("When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly.").

105. 532 U.S. 275 (2001).

106. *Id.* at 286-89 (quoting *California v. Sierra Club*, 451 U.S. 287, 294 (1981)).

107. 536 U.S. 273 (2002).

108. *Id.* at 284 n.3.

109. Statistics, *supra* note 31.

110. *Id.*

111. *See, e.g., Wilko v. Swan*, 346 U.S. 427, 438 (1953).

112. *Id.*

was unavailable for claims based on the Securities Acts because they severely undercut a harmed investor's ability to recover under those Acts.¹¹³ The Court noted that section 14 of the 1933 Act "void[s] any 'stipulation' waiving compliance with any 'provision' of the Securities Act. [An] arrangement to arbitrate is a 'stipulation,' and we think the right to select the judicial forum is the kind of 'provision' that cannot be waived under § 14 of the Securities Act."¹¹⁴ The underlying reason for the *Wilko* decision was that arbitrations were generally disadvantageous to buyers.¹¹⁵

In 1967, the Court changed its attitude towards arbitration.¹¹⁶ In *Prima Paint v. Flood & Conklin Manufacturing Co.*, the Court stated that there is a strong public policy in favor of arbitration.¹¹⁷ It has now become well established that the Federal Arbitration Act¹¹⁸ establishes a strong national policy in favor of arbitration.¹¹⁹

In 1987, the Court specifically held that disputes arising under the 1933 and 1934 Acts are subject to arbitration.¹²⁰ While the Court declined to expressly overrule *Wilko*, it severely limited the holding to its facts.¹²¹ The Court held that

the mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time. This is especially so in light of the intervening changes in the regulatory structure of the securities laws. Even if *Wilko*'s assumptions regarding arbitration were valid at the time *Wilko* was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority.¹²²

Though the *Shearson/American Express, Inc. v. McMahon* decision did not expressly overturn *Wilko*, it was incongruous for the two decisions to exist simultaneously.¹²³ In 1989, the Court recognized this incongruity and

113. *Id.*

114. *Id.* at 434-35.

115. *Id.* at 435-36. "Even though the provisions of the Securities Act, advantageous to the buyer, apply, their effectiveness in application is lessened in arbitration as compared to judicial proceedings." *Id.* at 435.

116. See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967) (stating the public policy support for arbitration).

117. *Id.*

118. Federal Arbitration Act, 9 U.S.C. §§ 1-14 (2000).

119. *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097, 1112 (N.D. Cal. 2003). "The Federal Arbitration Act was designed to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate, and place such agreements upon the same footing as other contracts." *Id.* (citing *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Jr. Univ.*, 489 U.S. 468, 474 (1989) (internal quotations omitted)); see also *Moses H. Cone Mem'l. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983) (holding that the Arbitration Act establishes a "federal policy favoring arbitration").

120. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987).

121. *Id.*

122. *Id.* at 233.

123. See *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484 (1989) (explaining the incongruity between the *Wilko* and *McMahon* decisions).

expressly overruled *Wilko*.¹²⁴ Finding that “*Wilko* was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions,” the Court established arbitration as the prevailing policy even for violations of the 1933 and 1934 Acts.¹²⁵

In the aftermath of the *Rodriguez de Quijas v. Shearson/American Express, Inc.*¹²⁶ and *McMahon*¹²⁷ decisions, which held that federal securities acts claims could be arbitrated, the brokerage firms fully endorsed arbitration, resulting in arbitration clauses in virtually all customer-broker agreements.¹²⁸ The investing public used arbitration as a way to settle claims.¹²⁹ Today, failure to supervise claims are among the most frequently raised claims in NASD arbitrations.¹³⁰ The basis for raising such claims in an arbitration setting is evident in the historical development of the failure to supervise claims and securities arbitration.¹³¹

The Maloney Act Amendments to the 1934 Act require that broker-dealers be members of a national securities association¹³² or be associated with one.¹³³ The 1975 amendments to the 1934 Act vested in the SEC powers of oversight over SRO arbitration programs.¹³⁴ If either the SEC, using its oversight powers over arbitration,¹³⁵ or the NASD, which all broker-dealers are either members of or associated with,¹³⁶ allows failure to supervise claims in arbitration then there is a strong presumption that the courts will uphold the ruling given the wide deference given to arbitration.¹³⁷

124. *Id.*

125. *See id.*

126. *Id.* at 477.

127. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

128. *See Statistics, supra* note 31.

129. *See id.*

130. In 2003, 3230 failure to supervise claims were brought, making it the fourth largest type of claim brought. *Id.*

131. *See infra* notes 132-50 and accompanying text.

132. As of the date of this publication, the NASD is the only qualified national securities association.

133. Maloney Act, Pub. L. No. 719, 52 Stat. 1070 (1938) (codified as amended in scattered sections of 15 U.S.C.).

134. *See* 15 U.S.C. § 78u(a)(1) (2000).

135. *Id.*

136. *See* 52 Stat. at 1070.

137. *See supra* note 119 and accompanying text; *see also* *Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 89 (2000) (noting that “we have recognized that federal statutory claims can be appropriately resolved through arbitration, and we have enforced agreements to arbitrate that involve such claims”); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484 (1989) (stressing “the strong language of the Arbitration Act, which declares as a matter of federal law that arbitration agreements ‘shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract’” (quoting 9 U.S.C. § 2 (1982))).

The NASD permits, but does not require, that members make use of arbitration clauses.¹³⁸ Many members do use them¹³⁹ and their content is regulated by the NASD to protect investors from unfair arbitration clauses.¹⁴⁰ The typical arbitration clause is very broad and may encompass failure to supervise claims.¹⁴¹

The NASD, pursuant to requests for cheaper litigation, promulgated NASD Rule 10301.¹⁴² Rule 10301 applies when there is no arbitration clause and mandates that

any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer.¹⁴³

The phrase “arising in connection with the business” is very broad and could encompass a violation of NASD rules, including failure to supervise.¹⁴⁴ Thus under the Court’s recent interpretations of the Federal Arbitration Act, if an arbitration agreement is in place, a plaintiff will be able to arbitrate a failure to supervise claim.¹⁴⁵

The NASD and SEC gave further credence to the practice of allowing private causes of action in arbitrations, specifically in connection with failure to supervise claims, through a NASD Notice to Members.¹⁴⁶ The NASD Notice to Members 99-90 stated that the SEC “approved the use of

138. NASD, Arbitration, http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&nodeId=523&ssSourceNodeId=887 (last visited Jul. 1, 2005).

139. *See, e.g.*, U.S. Gen. Accounting Office, Follow-up Report on Matters Relating to Securities Arbitration (2003) (“[M]ost broker-dealers require customers, when opening an account, to sign a customer agreement that includes a predispute arbitration clause.”).

140. *See* NASD, Inc., Rule of Conduct 3110(f); *see also* Notices, 69 Fed. Reg. 232 (Dec. 3, 2004). The SEC, in response to complaints that investors are not adequately forewarned of the effects of arbitration, recently added stricter disclosure rules regarding the content of pre-dispute arbitration clauses. *Id.*

141. *See* NASD, Inc., Rule of Conduct 3110(f); *see also* Notices, 69 Fed. Reg. 232, (listing rule filings governing the content of arbitration clauses in customer-broker agreements).

142. *See* NASD, Inc., Rule of Procedure 10301 (2001), available at <http://nasd.complinet.com/nasd/display/index.html>.

143. *Id.*

144. *Id.* (internal quotations omitted). The U.S. Court of Appeals for the Sixth Circuit has issued instruction on the scope of NASD Rule 10301. *See Vestax Secs. Corp. v. McWood*, 280 F.3d 1078, 1081 (6th Cir. 2002). In *USAllianz Secs., Inc. v. S. Mich. Bancorp, Inc.*, the court, relying on the *Vestax* decision, held that “a dispute that arises from a firm’s lack of supervision ‘arises in connection with its business’ under NASD Rule 10301(a).” 290 F. Supp. 2d 827, 830 (W.D. Mich. 2003); *see also* IFG Network Secs. v. King, 282 F. Supp. 2d 1344, 1351 (M.D. Fla. 2003).

145. *See supra* notes 126-31 and accompanying text.

146. NASD, Inc., Notice to Members 99-90, at 687 (Nov. 1999), available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_005118.pdf.

the Discovery Guide . . . in National Association of Securities Dealers, Inc. . . . arbitration proceedings involving customer disputes with firms and associated persons."¹⁴⁷ The Discovery Guide is meant to "provide[] guidance to parties on which documents they should exchange without arbitrator or staff intervention."¹⁴⁸ List 5 and List 6 pertain only to private claims of failure to supervise.¹⁴⁹ The Notice specifies that the production list is "intended for use by arbitrators in customer arbitrations only,"¹⁵⁰ clearly differentiating this from an SEC enforcement proceeding. Thus, the SEC and NASD allow a private cause of action for violation of Rule 3010, even though the Supreme Court's logic in the *Central Bank*,¹⁵¹ *Transamerica*,¹⁵² and *Touche Ross*¹⁵³ decisions denied the remedy in litigation.¹⁵⁴ This Note seeks to address this contradiction. The law on this issue has become particularly unsettled in light of the securities laws passed in recent years in the wake of the accounting scandals.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Cent. Bank v. First Interstate Bank*, 511 U.S. 164 (1994).

152. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

153. *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

154. The question remains why, if the courts have consistently ruled that there is no private cause of action in litigation, a broker-dealer should object to an unfavorable award in arbitration. Even if an unfavorable award is issued, the defendant can appeal the arbitration and have the award vacated. The answer lies in the dangers of arbitration. Notwithstanding the additional cost of having to appeal the result of an arbitration following an improper award, there are two problems with allowing the claim to even be raised in arbitration. First, an arbitration panel is not required to state any ground for its opinion. *See* NASD, Inc., Rule of Procedure 10330. It is sufficient merely to detail the decision. *Id.* Secondly, even if an arbitration panel explicitly said that the award was based only on violation of the failure to supervise, the standard for vacating is quite high and varies depending on the jurisdiction. *See* *Mantle v. Upper Deck Co.*, 956 F. Supp. 719, 726 (N.D. Tex. 1997). "The standard of review for arbitration awards has been described as 'among the narrowest known to the law.'" *Id.* (citation omitted); *see also* *Wallace v. Buttar*, 378 F.3d 182, 189 (2d Cir. 2004).

A motion to vacate filed in a federal court is not an occasion for *de novo* review of an arbitral award. "It is well established that courts must grant an arbitration panel's decision great deference. A party petitioning a federal court to vacate an arbitral award bears the heavy burden of showing that the award falls within a very narrow set of circumstances delineated by statute and case law."

Id. (quoting *Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.3d 383, 388 (2d Cir. 2003)). In New York, if the defendant proved the high standard of "manifest disregard of the law," it would justify vacating the award, assuming there were no other viable way to uphold the award, even using logic not relied upon by the arbitration panel. *See* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933-34 (2d Cir. 1986). Not all courts have followed this reasoning. *See* *Mantle*, 956 F. Supp. at 726-27 ("Some courts have also considered 'manifest disregard of the law' as a proper basis for vacating an award. The Fifth Circuit holds, however, that § 10 of the Federal Arbitration Act sets forth the exclusive grounds on which vacatur may be founded." (citing *McIlroy v. PaineWebber, Inc.*, 989 F.2d 817, 820 (5th Cir. 1993) (per curiam))).

6. Recent Litigation Reopens the Debate

Following the Enron, WorldCom, and other accounting scandals, Congress passed the Sarbanes-Oxley Act of 2002.¹⁵⁵ Although omitted from the final text of the Act, representatives discussed enhancing the abilities of private litigants to enforce securities claims.¹⁵⁶ Thus, while an express private cause of action is not yet forthcoming, the debate is still raging.¹⁵⁷

II. SHOULD A PRIVATE REMEDY EXIST FOR VIOLATIONS OF NASD RULE 3010?

This part analyzes the interplay of the case law, industry practice, policy, and emerging legislation that affect whether a private action remedy should exist for violation of failure to supervise rules. Part II.A details the reasons against implying a private right of action. Specifically, Part II.A details the ample court decisions against implying a private right of action, discusses the industry norm of claiming failure to supervise in arbitrations, and analyzes the policy considerations that underlie the jurisprudence. Part II.A also asserts reasons for the continued denial of the implied right in light of recent litigation. Part II.B, by contrast, focuses on reasons for implying a private cause of action for violation of failure to supervise rules. Part II.B analyzes case law supporting implication, as well as industry practice, the policy issues at play, and the impact that recent legislation has on this issue.

A. *Cases and Policies Advocating that There Should Not Be a Private Cause of Action for Violation of the Failure to Supervise Rule*

This part analyzes the case law, which overwhelmingly supports denying private remedies.¹⁵⁸ It also discusses the policy considerations that underlie the decisions. Finally, it examines the impact that the Sarbanes-Oxley bill has on this issue.

1. Certain Case Law Supports Denying a Private Remedy

Over the past twenty-five years, judicial decisions show a progression toward a more textualist approach.¹⁵⁹ This part tracks the initial split among the circuit courts on this issue,¹⁶⁰ the Supreme Court's initial move toward textualism,¹⁶¹ the Ninth Circuit's application of textualism to the

155. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (to be codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

156. Lewis D. Lowenfels & Alan R. Bromberg, *Implied Private Actions Under Sarbanes-Oxley*, 34 Seton Hall L. Rev. 775, 781 (2004).

157. See *infra* notes 332-42 and accompanying text.

158. See *infra* notes 178-217 and accompanying text.

159. See *infra* notes 178-217 and accompanying text.

160. See *infra* Part II.A.1.a.

161. See *infra* Part II.A.1.b.

question of violations of NASD rules,¹⁶² as well as the Court's revolutionary embrace of textualism in a Rule 10b-5 setting.¹⁶³ Additionally, this part explains the role arbitration has in judicial decision-making.¹⁶⁴

a. *Seeds for Denial*

Before *Cort v. Ash*,¹⁶⁵ courts were split on whether and under what conditions a private cause of action could be implied.¹⁶⁶ Under the rule laid down in *Colonial Realty Corp. v. Bache & Co.*¹⁶⁷ by Judge Friendly, a private right of action does not exist because the duty to supervise rule is not "an explicit duty unknown to the common law,"¹⁶⁸ but rather should be regulated on other levels.¹⁶⁹ After *Cort*, analyzing whether to imply a private right of action depended on applying the four-factor test.¹⁷⁰

Based on the aforementioned criteria, it is unclear whether a private cause of action should be implied for violation of the failure to supervise rule. *Cort* gave no indication of how to weigh the four factors.¹⁷¹ While proponents of implying a remedy could argue that the securities acts, upon which a failure to supervise claim is at least tangentially based,¹⁷² were designed for the protection of investors,¹⁷³ opponents could counter by arguing that there is no indication whether this factor, standing alone, is sufficient. There is no explicit textual support for implying the private action, arguably the most dominant factor in the *Cort* test as evidenced by the subsequent *Transamerica* and *Touche Ross* decisions.¹⁷⁴ Opponents of the remedy argue that implying a cause of action is not "consistent with the underlying purposes of the legislative scheme."¹⁷⁵ Lastly, the cause of action is "one traditionally relegated to state law,"¹⁷⁶ because one could sue

162. See *infra* Part II.A.1.c.

163. See *infra* Part II.A.1.d.

164. See *infra* Part II.A.1.e.

165. 422 U.S. 66 (1975).

166. See *supra* Part I.B.1.

167. 358 F.2d 178, 182 (2d Cir. 1966).

168. *Id.*

169. For example, it could be regulated through tort principles, respondeat superior, or conspiracy. See *infra* notes 254-67 and accompanying text.

170. See *supra* Part I.B.2.

171. See *Cort v. Ash*, 422 U.S. 66, 78 (1975).

172. *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679-80 (9th Cir. 1980) (noting that some proponents for implying remedies for a violation of exchange rules found basis in the securities statutes); see also *Securities Regulation—Federal*, *supra* note 94, § 1605.

173. See Securities Industry Association, Comprehensive Investor Protection Statutes, http://www.sia.com/capitol_hill/html/protection_statutes.html (last visited July 2, 2005).

174. Without an indication of how to weigh the four factors, projecting how a court would decide each individual case is conjecture.

175. *Cort*, 422 U.S. at 78.

176. *Id.*

under the theory of respondeat superior, a state law action.¹⁷⁷ Thus, *Cort* does not provide adequate evidence for either side.

b. *The Court Embraces a Textual Approach to Implying Causes of Action*

Regardless of whether a private cause of action would be implied under *Cort*, the Supreme Court decisions in *Transamerica*¹⁷⁸ and *Touche Ross*¹⁷⁹ essentially shut the door on the issue of whether a private right of action could be implied for violation of the failure to supervise rule.¹⁸⁰ Rather than following the full four-factor test, the two decisions focused exclusively on congressional intent.¹⁸¹ The intent, which must “appear implicitly in the language or structure of the statute, or in the circumstances of its enactment,” cannot support implication of the remedy.¹⁸² Even though it is conceded that the act was to benefit investors, this is an insufficient reason to imply a remedy.¹⁸³ “[T]he mere fact that [a] statute was designed to protect advisers’ clients does not require implication of a private cause on their behalf.”¹⁸⁴ Instead, the sole task is to determine “whether Congress intended to create the private right.”¹⁸⁵ Additionally, the silence in the legislative history that the Court found so compelling in *Touche Ross*¹⁸⁶ exists here when trying to imply a cause of action regarding failure to supervise.¹⁸⁷ Therefore, under the *Transamerica* and the *Touche Ross* standards, a private cause of action should not be implied.¹⁸⁸

177. For examples of persons suing in state court for respondeat superior in addition to failure to supervise, see *Champion Parts, Inc. v. Oppenheimer & Co.*, 878 F.2d 1003 (7th Cir. 1989); *Carroll v. John Hancock Distribs.*, No. 92-5907, 1994 U.S. Dist. LEXIS 3077 (E.D. Pa. Mar. 11, 1994); *Borchers v. DBL Liquidating Trust (In re Drexel Burnham Lambert Group, Inc.)*, 161 B.R. 902 (Bankr. S.D.N.Y. 1993).

178. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

179. *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

180. See *Ryan v. Illinois*, No. 91 C 3725, 1996 U.S. Dist. LEXIS 5160 (N.D. Ill. Apr. 17, 1996). The court in *Ryan* noted the following:

In *Thompson v. Thompson*, Justice Scalia noted in his concurring opinion that the Supreme Court effectively overruled the *Cort v. Ash* analysis in *Touche Ross & Co. v. Redington* and *Transamerica Mortgage Advisors, Inc. v. Lewis*. The Supreme Court in *Thompson* held that unless the legislative intent can be inferred from the language of the statute, or some other source, a private remedy will not be implied.

Id. (citations omitted).

181. *Transamerica*, 444 U.S. at 23-24; *Touche Ross*, 442 U.S. at 568.

182. *Transamerica*, 444 U.S. at 18.

183. *Id.*

184. *Id.* at 24 (citations omitted).

185. *Touche Ross*, 442 U.S. at 568.

186. See *supra* notes 73-74 and accompanying text.

187. Failure to supervise is completely absent from legislation. Instead it is an NASD rule. See NASD, Inc., Rule of Conduct 3010.

188. Some commentators stated in the wake of those decisions “that although the decisions in *Touche Ross* and *Transamerica* are restrictive in terms of implying private federal rights of action under statutes which do not provide a right of action, they should not be viewed as foreclosing the possibility of future judicial inference.” Eichelberger, *supra* note 45, § 2 (citing Mark I. Steinberg, *Implied Private Rights of Action under Federal Law*, 55 Notre Dame L. Rev. 33 (1979)). This statement did not prove to be entirely prescient.

c. *Courts Reject Private Causes of Action for Violations of NASD Rules*

The previous three cases dealt with implying private causes of action directly from a statute. Under that analysis, using the *Cort* test, it would be possible to imply a private cause of action,¹⁸⁹ whereas if one uses the “intent” test, it would be unclear whether a private cause of action could be implied.¹⁹⁰ Applying the Court’s analysis to supervisory rules may be further complicated because the failure to supervise rule is not actually embodied in a statute but is just a Conduct Rule.¹⁹¹ To imply a private cause of action here, it is necessary to argue that “[a]lthough the rules of the [NASD] are not federal statutes . . . they are equivalent to federal statutes because they were enacted by the NASD pursuant to its rulemaking powers under § 15A(b)(6) and § 19(g) of the Exchange Act.”¹⁹² This argument is difficult in light of the *Transamerica* decision holding that if a statute

Subsequent decisions refused to imply rights of action in the Second, Third, and Ninth Circuits. *Id.* Even the courts unwilling to make a blanket rule “have stated that the party urging the implication of a federal right of action for violation of an exchange or NASD rule carries a considerably heavier burden of persuasion than when the violation is of the Securities Exchange Act or of a Securities Exchange Commission regulation.” *Id.*

189. See *supra* Part II.A.1.a.

190. See *supra* Part II.A.1.b.

191. See NASD, Inc., Rule of Conduct 3010.

192. *Securities Regulation—Federal*, *supra* note 94, § 1605. The Securities Exchange Act of 1934 states as follows:

(b) Determinations by Commission requisite to registration of applicant as national securities association. An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that—

(6) The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this [title] matters not related to the purposes of this [title] or the administration of the association.

15 U.S.C. § 78o-3 (2000); see also 15 U.S.C. § 78s. The statute also states the following:

(g) Compliance with rules and regulations.

(1) Every self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and (subject to the provisions of section 78q(d) of this title, paragraph

(2) of this subsection, and the rules thereunder) absent reasonable justification or excuse enforce compliance—

(A) in the case of a national securities exchange, with such provisions by its members and persons associated with its members; (B) in the case of a registered securities association, with such provisions and the provisions of the rules of the Municipal Securities Rulemaking Board by its members and persons associated with its members; and (C) in the case of a registered clearing agency, with its own rules by its participants.

Id.

expressly provides a remedy, as the rulemaking compliance statute does,¹⁹³ a court should not imply one.¹⁹⁴ Additionally, several courts have specifically stated that a violation of NASD rules, or in similarly related cases, violation of exchange rules, does not create a private cause of action.¹⁹⁵

In *Jablon v. Dean Witter & Co.*,¹⁹⁶ the Ninth Circuit specifically answered the question of whether to imply a private right of action for a violation of NASD rules, addressing the issue in a post-*Transamerica* and *Touche Ross* framework. The *Jablon* court, forced to apply *Transamerica* and *Touche Ross* to the more indirect scenario of implying a cause of action for the violation of an NASD rule—which can only be said to have a statutory basis indirectly by implying a cause of action through the Exchange Act—added an extra layer of testing that made it even more difficult to imply a private cause of action.¹⁹⁷ The Ninth Circuit said that

[b]ecause the stock exchange rules were not enacted by Congress but by the exchange acting on authority delegated by Congress, a two-step inquiry is necessary: (1) whether Congress intended to delegate authority to establish rules implying a private right of action; (2) whether the stock exchange rules were drafted such that a private action may legitimately be implied.¹⁹⁸

The Ninth Circuit then conducted the first prong of its analysis and found “that Congress did not intend to create private rights of action for violation of stock exchange rules.”¹⁹⁹ The *Jablon* court equated the New York Stock

193. The Securities Exchange Act of 1934 states the following:

The rules of the association provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this chapter, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

15 U.S.C. § 78o-3(b)(7) (2000).

194. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19 (1979) (noting that “it is an elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it”).

195. See *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980); *Birotte v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 468 F. Supp. 1172, 1179 (D.N.J. 1979) (“Rule 405 simply does not meet the second and third parts of the *Cort* guidelines; that is, there is no indication that Congress intended to create a remedy for violation of these rules, and implication of such a remedy would be inconsistent with the legislative scheme.”). But see *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 160 (8th Cir. 1977) (allowing implication of a private right of action for violation of exchange rules in the limited cases where there is a finding of fraud).

196. 614 F.2d at 677.

197. The additional layer required determining whether Congress intended to delegate the authority to establish rules implying private remedies. *Id.* at 679. This is the first step of the two-part inquiry. *Id.*

198. *Id.*

199. *Id.*

Exchange question with the NASD question.²⁰⁰ It dismissed the reasons traditionally listed for implying a private cause of action, saying that because of the new and proper “restrictive approach to implying private rights of action,” the old reasons are no longer valid.²⁰¹

The Ninth Circuit then turned to the NASD rules, an issue directly parallel to the failure to supervise claim.²⁰² After casting away any claim of an explicit remedy in the 1933 and 1934 Acts, the court denied the petitioners’ argument that “a private right is implicit because § 15A(b)(6) of the Securities Exchange Act . . . establishes an actionable duty under § 27.”²⁰³ Additionally, the court found it compelling that there was no explicit provision granting a cause of action, especially because other parts of the Exchange Act specifically provide for such.²⁰⁴ Instead, *Jablon* cited language of *Touche Ross* and *Transamerica*: “Our conclusion that neither § 6(b) nor § 15A(b)(6) provides private rights of action is further supported by the fact that sections 9(e), 16(b), and 18 of the Securities Exchange Act explicitly provide private rights of action.”²⁰⁵ The *Jablon* court noted that the Supreme Court itself refused to imply a remedy into section 17(a) of the Act because “when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly.”²⁰⁶

Thus, under the test laid down by *Jablon*, failure to supervise claims would fail because of a lack of congressional intent to create a private right and, even if this problem could be sidestepped, the claimant would still bear the burden of proving that the NASD intended to create this right upon enactment of the rule.²⁰⁷ There is no support for a finding that this result is what the NASD intended by promulgating Conduct Rule 3010.

d. *The Court Restricts Traditionally Implied Actions*

The Supreme Court took the argument even further in *Central Bank of Denver v. First Interstate Bank of Denver*.²⁰⁸ By sounding the death knell for the long-established practice of implying a private cause of action in relation to aiding and abetting, the Court instead trumpeted a new era of adhering to strict textualism even in the face of equity and policy

200. *Id.*

201. *Id.* After establishing that the only determinative factor is congressional intent, the Court found that a private cause of action could not be implied “[b]ecause we find no [c]ongressional intent to provide a private action for violation of stock exchange rules.” *Id.* at 681.

202. *See id.*

203. *Id.*

204. *Id.* This is a common principle in law known as *expressio unius est exclusio alterius*—“To express or include one thing implies the exclusion of the other, or of the alternative.” Blacks’s Law Dictionary 687 (8th ed. 2004).

205. *Jablon*, 614 F.2d at 681.

206. *Id.* (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979)).

207. *Id.* at 679.

208. 511 U.S. 164 (1994).

arguments.²⁰⁹ The Court recognized that “[t]he issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.”²¹⁰ The Court, in an argument that applies to secondary liability for failure to supervise, in addition to the aiding and abetting issue that the Court was addressing, noted that “Congress did not overlook secondary liability when it created the private rights of action in the 1934 Act. Section 20 of the 1934 Act imposes liability on ‘controlling person[s].’”²¹¹ This is particularly important because it “suggests that ‘[w]hen Congress wished to create such [secondary] liability, it had little trouble doing so.’ . . . The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.”²¹²

Even the dissent,²¹³ which was not willing to dismiss precedent allowing private liability for aiders and abettors, recognized the danger that the decision posed for implying any form of secondary liability, such as the failure to supervise.²¹⁴ The dissent noted that if not for the stare decisis argument, “[m]any of the observations in the majority’s opinion would be persuasive.”²¹⁵ This was because the “approach to implied causes of action . . . has changed markedly since the Exchange Act’s passage in 1934. . . . [C]ourts regularly assumed . . . that a statute enacted for the benefit of a particular class conferred on members of that class the right to sue violators of that statute.”²¹⁶ Thus, *Central Bank* requires application of the congressional intent test of *Touche Ross* even for well-established areas of law that had always implied private causes of action.²¹⁷

e. *Cases Relating to Arbitration that Argue Denying a Remedy Is Required in Arbitration*

Although courts have generally held that failure to supervise claims are arbitrable,²¹⁸ arbitrators have acted as gatekeepers by granting dismissal motions²¹⁹ on the grounds that claimants’ private causes of action are for

209. *See id.* at 187-88.

210. *Id.* at 177.

211. *Id.* at 184.

212. *Id.* (citations omitted).

213. *Id.* at 192 (Stevens, J., dissenting). The decision was a 5-4 split.

214. *Id.* (Stevens, J., dissenting) (“The majority gives short shrift to a long history of aider and abettor liability under § 10(b) and Rule 10b-5, and . . . its rationale imperils other well-established forms of secondary liability not expressly addressed in the securities laws . . .”).

215. *Id.* at 195.

216. *Id.*

217. *See, e.g.,* *Corr. Servs. Corp. v. Malesko*, 534 U.S. 61, 67 (2001).

218. *See supra* Part I.B.5.

219. “The courts have upheld arbitrators granting of dismissal motions . . . on the grounds of the timeliness of the claims, a respondent’s involvement in the matter in controversy, or whether the claimant has a private right of action for alleged violation of an SRO rule.” U.S. Gen. Accounting Office, *Follow-up Report on Matters Relating to Securities Arbitration* 8 (2003).

alleged violations of SRO rules.²²⁰ Therefore, while arbitration has provided an outlet for these claims to be raised, they have not provided an outlet for the claims to be sustained.²²¹ Thus, in litigation the courts have overwhelmingly denied private remedies, while even in arbitrations, although claims are technically allowed in the door, they are often dismissed as a matter of course.²²²

2. Denying a Private Remedy Is Sound Policy

While the Supreme Court has espoused a textualist approach in recent years that essentially forecloses arguments for implication,²²³ the policies that drive these arguments are still important.²²⁴ Over time the makeup of the Court may change, leading to different views on the issue.²²⁵

From a policy standpoint there are several reasons why there should not be an implied private cause of action. First, implication of remedies involves the courts usurping the role of Congress in promulgating laws. It allows the courts to reshape laws to mean not what they say, but rather what they might have said otherwise.²²⁶ Second, even if the private action remedy was explicit in the statute, and thus clearly existed, that may not mean that the existence of the right was good policy.²²⁷ There is a concern that allowing private remedies would lead to increased litigation, particularly frivolous litigation, in attempts to garner settlements.²²⁸ Congress has repeatedly warned of the danger of allowing that to happen.²²⁹ Lastly, there should not be a private cause of action because the remedy is

220. See, e.g., *Sears v. Nirenberg*, No. 99-02955, 2000 NASD Arb. LEXIS 782, at *7 (Jan. 21, 2000) (“The NASD Rules of Fair Practice do not contain a private right of action and thus the Panel finds in favor of Respondents based on allegations of a *per se* violation of those rules.”)

221. *Id.*

222. See *Sheldon v. Vermonty*, 269 F.3d 1202, 1206 (10th Cir. 2001) (“Although NASD’s procedural rules do not specifically address whether an arbitration panel has the authority to dismiss facially deficient claims with prejudice based solely on the pleadings, there is no express prohibition against such a procedure.”); see also *Warren v. Tacher*, 114 F. Supp. 2d 600, 602 (W.D. Ky. 2000) (“Courts have recognized the authority of NASD arbitrators to decide pre-hearing dismissals for failure to state a claim under the NASD Code.”); *Prudential Secs., Inc. v. Dalton*, 929 F. Supp. 1411, 1417 (N.D. Okla. 1996) (allowing dismissal of claims if no relief can be granted).

223. See *supra* Parts II.A.1.

224. For examples of the countervailing arguments, see *infra* Part II.B.3.

225. Some courts have already tried abandoning the textualist approach. See James N. Benedict, *Recent Developments in Litigation under the Investment Company Act of 1940*, in *Practising L. Inst., Corporate Law & Practice Course Handbook Series 1192* (2004). In *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783, 797 (S.D.N.Y. 1997), “the court considered the question of whether implied rights of action still existed . . . in light of Central Bank. In finding that such rights did exist, the court ignored the Supreme Court’s marked aversion toward implied rights.” Benedict, *supra* note 225, at 1192.

226. See *infra* notes 232-41 and accompanying text.

227. For policy reasons not to allow a private remedy for failure to supervise, see *infra* Part II.A.2.b-c.

228. See *infra* note 245 and accompanying text.

229. See *infra* note 248.

unnecessary.²³⁰ There are currently sufficient deterrents placed in front of broker-dealers to encourage compliance and sufficient avenues by which harmed investors can be made whole.²³¹

a. *Courts Are Usurping the Role of Congress*

The first policy argument is that the courts are overstepping their bounds when they try to reinterpret Congress's intentions.²³² This is not a novel argument and has divided the courts since their inception.²³³ Article I of the U.S. Constitution vests legislative power exclusively in Congress.²³⁴ American politicians as far back as Alexander Hamilton envisioned "that the judiciary would be the 'weakest' branch of government."²³⁵ According to Thomas Jipping,²³⁶ a judge's role is to interpret the law, not inject Congress's intent into the law.²³⁷ Jipping contrasts the activist judge, a rising threat in his view, with the restrained judge, the paradigm of proper judicial response.²³⁸ Thus "[t]here exist two basic choices, a restrained judge who is a servant of the law, or an activist judge who is the master of the law."²³⁹ As a practical matter, Jipping contrasts the activist judge with the restrained, argues as follows:

A restrained judge believes that the meaning of these words already exists, that the meaning came from the legislatures or the people who enacted those words into law in the first place, and the judge's job is to find it. Activist judges, in contrast, pursue their own agendas and believe they can give those words any meaning they choose.²⁴⁰

More critically, he states that "[a] restrained judge takes the law as he finds it, while the activist judge believes he can make it up as he goes along, usually as a way of reaching the results he wants."²⁴¹

Alexander Hamilton explained the need for judges to act in a restrained manner: "if [judges] should be disposed to exercise will instead of judgment, the consequences would equally be the substitution of their

230. *See infra* Part II.A.2.c.

231. *See infra* Part II.A.2.c.

232. Thomas L. Jipping, *Disorder In The Court: Activist Judges Threaten Justice*, <http://www.leaa.org/Shield%202000/activistjudge.html> (last visited July 2, 2005). Jipping is the Director of the Free Congress Foundation's Judicial Selection Monitoring Project in Washington, D.C. *Id.*

233. *Id.* The issue of judicial activism has been the subject of much debate lately. *See* Janine DeFao, *Judicial Activism on the Docket at Stanford Event*, S.F. Chron., Oct. 24, 2004, at A7. "President Bush has cited 'activist judges' in Massachusetts who declared same-sex marriage constitutional as the reason he backs a constitutional amendment that limits marriage to a man and a woman." *Id.*

234. U.S. Const. art. I, § 1.

235. Jipping, *supra* note 232.

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.*

pleasure to that of the legislative body.”²⁴² Therefore, in order to maintain the integrity of our American legal system, which prides itself on the separation of powers, we must adopt a strict textualist approach and refrain from implying a private cause of action for violations of NASD rules.

b. *Allowing a Private Remedy Leads to Frivolous Litigation*

The second reason that is given for not creating a private cause of action is that doing so may be poor economic policy.²⁴³ In contrast to the textualism argument, which passes no judgment on the substantive policy question of what Congress should do on the issue, but instead takes offense to the judiciary branch overstepping its bounds,²⁴⁴ the second reason attacks the merits of creating a private remedy.

Policy, particularly that which has driven congressional action, may dictate that no right of private remedy should exist due to the fear of excessive frivolous litigation. In 1995, the Senate Subcommittee on Securities found that there were high numbers of frivolous securities suits being filed in hopes of achieving a quick settlement.²⁴⁵ These suits increase costs of capital²⁴⁶ and can also have a chilling effect on investing.²⁴⁷ If private individuals are permitted to bring actions in the limited number of arguably justified cases, it may open the floodgates for numerous frivolous lawsuits.²⁴⁸ Such frivolous lawsuits are particularly insidious with regard to securities because even if the threat of liability is remote, the potential liability is so large as to spur settlement.²⁴⁹ Chairman Alfonse D’Amato stressed this, recognizing that “the threat of such liability often forces innocent ‘deep pocket’ defendants to settle frivolous suits.”²⁵⁰ Arthur Levitt, then-Chairman of the SEC, added that “there is a danger that weak claims may be overcompensated while strong claims are undercompensated.”²⁵¹ The Committee considered amending the Exchange

242. *Id.* (citations omitted, alteration in original).

243. See *infra* notes 245-53 and accompanying text.

244. See *supra* Part II.A.2.a.

245. S. Rep. No. 104-98, at 4 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683.

246. In 1992 and 1993, 145 such cases were settled for total payments of three billion dollars. William S. Lerach, *The Implications of the Private Securities Litigation Reform Act: The Private Securities Litigation Reform Act of 1995—27 Months Later*, 76 Wash. U. L.Q. 597, 600 (1998). In her testimony to the Subcommittee on Telecommunication and Finance of the House Committee on Energy and Commerce, Professor Janet Cooper Alexander stated that there “is a serious question whether the benefits, in the form of deterrence . . . justify the[] costs.” *Id.*

247. See *id.* (explaining the high cost of settlement for strike suits).

248. See *id.* Frivolous litigation, or “strike suits,” have been a particular concern in the area of securities. Kevin P. Roddy, *Eight Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, in Postgraduate Course in Federal Securities Law: Current Developments 141, 147 (Am. Law Inst. 2004). (explaining the need for enactment of the Private Securities Litigation Reform Act of 1995).

249. S. Rep. No. 104-98, at 4 (1995) (explaining the need for private securities litigation reform).

250. *Id.* at 7.

251. *Id.*

Act of 1934 to include private causes of action for aiding and abetting, expressly overruling *Central Bank of Denver v. First Interstate Bank*.²⁵² After much deliberation and hearing testimony both for and against amending the Act, the Committee decided not to add the express provision because it “would be contrary to [section] 240’s goal of reducing meritless securities litigation.”²⁵³

c. No Private Remedy Is Needed Because Adequate Deterrences and Alternate Remedies Exist

The final policy reason for denying the creation of a private remedy is that doing so is superfluous. There are already adequate remedies available for investors that have kept investor confidence in the markets high enough to withstand every dip that they have encountered since the Depression.²⁵⁴ “The securities laws generally provide adequate remedies for those injured . . .”²⁵⁵ Thus, additional remedies would be unnecessary. Remedies already available include common law respondeat superior and controlling-person liability.

Respondeat superior liability has a long history in tort law.²⁵⁶ The underlying premise of respondeat superior is that “[a] master is subject to liability for the torts of his servants committed while acting in the scope of their employment.”²⁵⁷ The traditional interpretation of respondeat superior provides that a “broker-dealer could be held vicariously liable for the wrongful acts of its representatives.”²⁵⁸ Under the doctrine of respondeat superior, there is no good faith defense.²⁵⁹ Thus, with respondeat superior already protecting investors’ rights, there is no need for further legislation.

Controlling-person liability stems from section 15 of the Securities Act²⁶⁰ and section 20(a) of the Exchange Act.²⁶¹ As a matter of law,

252. *Id.* at 19.

253. *Id.*

254. *Id.*

255. *Id.* (statement of Arthur Levitt, Former Chairman of the SEC).

256. See *Kohlman v. Hyland*, 210 N.W. 643, 646 (N.D. 1926).

257. Restatement (Second) of Agency § 219(1) (1958).

258. See *Johnson*, *supra* note 23.

259. This has been the traditional view. See, e.g., *N.Y. Cent. R.R. v. White*, 243 U.S. 188, 198 (1917).

260. 15 U.S.C. § 77o (2000). The statute states as follows:

Every person who . . . controls any person liable under sections 77k or 77i of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the fact by reason of which the liability of the controlled person is alleged to exist.

Id.

261. 15 U.S.C. § 78t(a). The statute states as follows:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person . . .

broker-dealers are controlling persons.²⁶² Because of this theory, brokerage firms have been forced to defend charges against controlling persons when they have failed to adequately supervise.²⁶³ Although the courts are split on what level of participation is needed for a controlling person to be held liable,²⁶⁴ the prevailing theory is that a plaintiff only need allege that the controlling person “had the power or ability to control the [controlled person].”²⁶⁵ This is the equivalent of a private cause of action for failure to supervise and is defensible by a showing of good faith.²⁶⁶ A showing of good faith is essentially a showing that the proper supervisory systems were in place.²⁶⁷ With the protection of controlling-person liability already in place, it becomes unnecessary to create a new cause of action.

While there have been calls for implying private rights of action in the wake of Enron and in the legislative history for Sarbanes-Oxley,²⁶⁸ Congress’s election not to include an explicit private action remedy in the text of Sarbanes-Oxley is indicative of a desire that there not be such a remedy.²⁶⁹ “The majority of the legislators who passed Sarbanes-Oxley, however, did not accept” the need to create a remedy of private action, and instead “appeared to militate against the expansion of implied private actions under the [Sarbanes-Oxley] Act.”²⁷⁰ Thus, the text of the final version of Sarbanes-Oxley does not support private actions but, rather,

unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id.

262. See Gerald F. Rath et al., *Selected Issues in Broker/Customer Litigation*, in *Securities Litigation Planning and Strategies* 133, 210 (Am. Law Inst. 2004) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)).

263. See Johnson, *supra* note 23; see also *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 887 (7th Cir. 1992) (failing to grant a motion of summary judgment for a brokerage firm accused of acting as a controlling person despite the firm having no knowledge of the employee’s actions).

264. Some courts require actual control. Compare *Harrison*, 974 F.2d at 881 (requiring no culpable participation, only ability to control), with *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974) (requiring a showing that the controlling person was “in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person[]” (quoting *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973))).

265. See Johnson, *supra* note 23; see also *Stavroff v. Meyo*, No. 95-4118, 1997 U.S. App. LEXIS 32774 (6th Cir. Nov. 12, 1997); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989); *Rochez Bros. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975).

266. See *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 393-94 (4th Cir. 1979).

267. *Id.* at 394. To prove one acted in good faith, “the controlling person [must] show that some precautionary measures were taken to prevent an injury caused by an employee. . . . It is required of the controlling person only that he maintain an adequate system of internal control, and that he maintain the system in a diligent manner.” *Id.* (internal citations omitted); see also *Hollinger*, 914 F.2d at 1576 (holding that in order to prove good faith a broker-dealer must prove that “its supervisory system was adequate and that it reasonably discharged its responsibilities under the system”).

268. See *supra* notes 155-56 and accompanying text.

269. See *supra* note 204.

270. Lowenfels & Bromberg, *supra* note 156, at 776, 781 (discussing the impact of Sarbanes-Oxley on private actions).

explicitly states that “[n]othing in this section shall create a new, private right of action.”²⁷¹

B. *Reasons for Allowing a Private Right of Action for Violation of NASD’s Failure to Supervise Rule*

There are several justifications for permitting a private right of action for failure to supervise. Several courts, although admittedly few since 1977, would allow implying the cause of action.²⁷² Also, the NASD has embraced the cause of action under the penumbra of Rule 10301—a view supported by the importance that courts have placed on arbitration.²⁷³ Additionally, policy concerns demand implication of the right.²⁷⁴ Lastly, recent legislation paves the way for implying the private action even if it was not there before.²⁷⁵

1. Certain Case Law Allows for Implying a Remedy in Litigation

Prior to 1977, some courts allowed implication of private rights of action. Although the Supreme Court has adopted a textualist approach in recent years, it is possible that a renaissance of legal doctrine that embraces legitimate policy concerns over literalism could return.²⁷⁶ Thus, this section analyzes the pre-1977 decisions.

In *Colonial Realty Corp. v. Bache & Co.*,²⁷⁷ rather than using a strict textualist approach, Judge Friendly advocated a case-by-case approach, recognizing that “[t]he case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.”²⁷⁸ In *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*²⁷⁹ the court implied a private cause of action holding that a violation of the rule would be actionable under the “public protection function.”²⁸⁰ Under either *Buttrey*²⁸¹ or *Colonial Realty*,²⁸² a remedy for failure to supervise might be implied. The circuit splits were settled with the decision in *Cort v. Ash*.²⁸³

271. 28 U.S.C.A. § 1658(804) (2004).

272. See *infra* Part II.B.1.

273. See *infra* Part II.B.2.

274. See *infra* Part II.B.3.a-d.

275. See *infra* Part II.B.3.e.

276. See *supra* note 45 and accompanying text (detailing how some courts have rejected the textualist approach).

277. 358 F.2d 178 (2d Cir. 1966).

278. *Id.* at 182.

279. 410 F.2d 135 (7th Cir. 1969).

280. *Id.* at 141.

281. Under the logic of *Buttrey*, one argument could be that the failure to supervise rules were promulgated to protect the investing public.

282. Arguably, there is no other common law duty governing failure to supervise. See *infra* notes 316-23 and accompanying text.

283. 422 U.S. 66 (1975).

Even following the Supreme Court's ruling in *Cort*, which laid out four factors for consideration,²⁸⁴ implying a cause of action may arguably still be permitted. Based on the aforementioned criteria, a private cause of action arguably should be implied for violation of the failure to supervise rule.²⁸⁵ The securities acts, upon which a failure to supervise claim is at least tangentially based,²⁸⁶ were designed for the protection of investors.²⁸⁷ Although there appears to be no textual indication of support for implying the private action, doing so is "consistent with the underlying purposes of the legislative scheme,"²⁸⁸ namely, to bring about fair securities exchanges and protect investors.²⁸⁹ Lastly, the cause of action is not "one traditionally relegated to state law,"²⁹⁰ because Congress specifically enabled private causes of action in numerous parts of the securities acts.²⁹¹

Advocates for not implying a private remedy argue that violations of SRO rules should be held to a more exacting standard due to the tenuous nexus between SRO rules and an explicit statute from which a cause of action could be implied.²⁹² This argument was undercut by a court's decision that noted the "federal duty" imposed upon a broker-dealer "to supervise" its representatives "derives from 15 U.S.C. § 78o."²⁹³

284. See *supra* notes 50-58 and accompanying text.

285. See *infra* notes 286-91 and accompanying text.

286. Cf. *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980); see also *Securities Regulation—Federal*, *supra* note 94, § 1605.

287. See *supra* notes 172-73 and accompanying text.

288. *Cort*, 422 U.S. at 78.

289. See *supra* note 173 and accompanying text.

290. *Cort*, 422 U.S. at 78.

291. See, e.g., Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r (2000) ("Any person who shall make . . . any statement . . . which . . . was at the time . . . false or misleading with respect to any material fact, shall be liable to any person . . . who . . . shall have purchased or sold a security . . . for damages caused by such reliance . . ."); *id.* § 78i ("Any person who willfully participates in any act or transaction in violation of subsection (a), (b), or (c) of this section, shall be liable to any person . . . injured [for] damages sustained as a result of any such act or transaction"). Since Congress created a federal private cause of action in the context of securities regulation, it cannot be said that securities regulation is "relegated to state law." *Cort*, 422 U.S. at 78.

292. See *supra* notes 189-206 and accompanying text.

293. *State v. Justin*, 3 Misc. 3d 973, 1000 (Sup. Ct. Erie County N.Y. 2003) (citing 15 U.S.C. § 78o-4 (2000)). Section 78o of the statute states as follows:

(4) The [SEC], by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds . . . that such [penalty] is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated— . . .

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933 [or certain other federal statutes], this chapter, the rules or regulations under any of such statutes, . . . or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.

For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

2. Case Law Allows a Private Remedy in Arbitration

NASD Rule 10301 and courts' application of the rule support implying a private cause of action. Rule 10301, which dictates under what conditions a claim may be brought in arbitration,²⁹⁴ are broad enough to encompass violations of NASD rules, that is, failure to supervise claims. In *IFG Network Securities, Inc. v. King*,²⁹⁵ the court analyzed whether a claim of negligent supervision can "arise[] in connection with the business activities of [an] NASD member."²⁹⁶ Citing a long string of cases,²⁹⁷ the court found that a "claim of negligent supervision satisfies the . . . NASD arbitration requirement."²⁹⁸ The court held that "[i]nasmuch as the NASD Code of Conduct requires [broker-dealers] to supervise its registered representatives, this Court finds that the . . . claim has a 'sufficient nexus' to [defendant's] business activities so as to entitle . . . arbitration in conformance with the NASD Code of Arbitration Procedure."²⁹⁹ Under this standard, then, the NASD rules regarding arbitration have already created a private cause of action for failure to supervise claims.

3. Policy Concerns Require a Private Remedy

Aside from the question of whether a cause of action already exists, there are several very strong policy reasons that would dictate that a private right of action should be created if it were deemed to not already exist. The reasons can be categorized under five broad headings: (1) tort principles allow it;³⁰⁰ (2) allowing private rights of action deters secondary actors from contributing to improper activities;³⁰¹ (3) without it, plaintiffs will be left without recourse, a dangerous proposition that might lead to an overall lack of confidence in the market;³⁰² (4) implying the remedy is consistent

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

15 U.S.C. § 78o(b)(4)(e).

294. See *supra* notes 126-50 and accompanying text.

295. 282 F. Supp. 2d 1344 (M.D. Fla. 2003).

296. *Id.* at 1356.

297. *Id.* at 1356-57 (citing *Vestax Sec. Corp. v. McWood*, 280 F.3d 1078, 1082 (6th Cir. 2002)) "'A dispute that arises from a firm's lack of supervision over its brokers arises in connection with its business.'" *Id.* at 1356 (quoting *Vestax Sec. Corp.*, 280 F.3d at 1082); *John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 58-59 (2d Cir. 2001) (same); *First Montauk Sec. Corp. v. Four Mile Ranch Dev. Co.*, 65 F. Supp. 2d 1371, 1379 (S.D. Fla. 1999) (same).

298. *IFG Network Securities*, 282 F. Supp. 2d at 1356.

299. *Id.* at 1357 (citations omitted).

300. See *infra* Part II.B.3.a.

301. See *infra* Part II.B.3.b.

302. See *infra* Part II.B.3.c.

with the intent behind allowing the existence of SROs;³⁰³ and (5) recent legislation shows that Congress wants a private remedy.³⁰⁴

a. *Tort Policies Favor Implying a Private Remedy*

Prior to the Supreme Court's decision in *Cort*, judges had relied on tort law to imply private rights of action.³⁰⁵ The first federal district court to recognize a private implied remedy did so based on the "tort maxim of *ubi jus ibi remedium*—where there is a right there is a remedy."³⁰⁶ Although the Court in *Cort* dismissed this theory in favor of the stricter four-factor test,³⁰⁷ the reasons for abandoning this trend might be oversimplified. That a right may not be listed explicitly may not automatically indicate that Congress did not want it to exist; Congress may have concluded that tort policy would obviously have been interwoven.³⁰⁸ The Court itself, in *Touche Ross*, indicated that silence on the issue in the text is not conclusive.³⁰⁹ Thus a return to tort policy, a sound system that places the costs on the cheapest cost avoiders, may be needed.³¹⁰

b. *A Private Remedy Is a Necessary Deterrent Against Impropriety*

Another reason in favor of allowing private causes of action is that it acts as a deterrent against improper activities. "Private actions under Sections 10(b) and 14(a) of the Exchange Act have long been recognized as a 'necessary supplement' to actions brought by the Commission and as an 'essential tool' in the enforcement of the federal securities laws."³¹¹ This is due to a lack of Commission resources:³¹²

303. See *infra* Part II.B.3.d.

304. See *infra* Part II.B.3.e.

305. See David J. Baum, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 Am. U. L. Rev. 1817, 1852 (1995) (citing *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946); Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80, 80 (1981).

306. Baum, *supra* note 305, at 1821 (citing *Kardon*, 69 F. Supp. at 513) (internal citations omitted).

307. See *supra* notes 50-58 and accompanying text.

308. *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 288 (1940) (noting that existing theories must be allowed because "[t]he power to enforce implies the power to make effective the right of recovery. . . . And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case").

309. *Touche Ross & Co. v. Reddington*, 442 U.S. 560, 571 (1979); see also *supra* notes 73-74 and accompanying text.

310. For a discussion of the cheapest cost avoider theory of tort liability, see G. Calabresi & J.T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 Yale L.J. 1055, 1060 (1972). See also S.G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost Avoider*, 78 Va. L. Rev. 1291 (1992).

311. S. Rep. No. 104-98, at 37 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 715-16.

312. *Id.*

Because the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets. . . . [P]rivate actions also provide a 'necessary supplement' to the Commission's own enforcement activities by serving to deter securities law violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.³¹³

The need for private rights of action is growing more essential and its importance is likely to increase, given the budgetary constraints on SEC resources.³¹⁴ The Director of the SEC's Division of Enforcement testified that "[g]iven the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection."³¹⁵ The same logic is applicable for violations of NASD rules, particularly the failure to supervise.

Without a private cause of action specific to failure to supervise claims, harmed investors would not be sheltered under either respondeat superior or the controlling-person doctrine. Respondeat superior liability traditionally did not contain a good faith defense, but this has been challenged by the Third Circuit's holding that in a securities setting respondeat superior is only imposed when a high level of public trust in the broker-dealer exists.³¹⁶ Thus a separate private remedy is needed to impose a fiduciary duty on broker-dealers to adequately supervise their employees. The question of whether respondeat superior is a remedy sufficient enough in scope as to make an explicit failure to supervise claim unnecessary is muddled further by the disagreement among the courts as to whether the controlling person provisions of the Exchange Acts preclude raising respondeat superior claims. Some courts have held that respondeat superior is inapplicable to brokerage firms because "Congress intended to supplant, rather than expand, common law liability when it enacted section 20(a) of the 1934 Act."³¹⁷ Following the *Central Bank* decision, in which the

313. *Id.* at 37-38 (Senators Paul S. Sarbanes, Richard H. Bryan, and Barbara Boxer, citing SEC Chairman Arthur Levitt's testimony before the House Subcommittee on Telecommunications and Finance on February 10, 1995).

314. *Id.* at 38. This argument may have been somewhat blunted because the SEC has recently received a large appropriation for increasing their enforcement staff. Securities Industries Association, SIA Press Release (Feb. 14, 2003), http://www.sia.com/press/2003_press_releases/html/pr_fy_03.html.

315. S. Rep. No. 104-98, at 38, as reprinted in 1995 U.S.C.A.N. 679, 715-16.

316. *See* Rath et al., *supra* note 262, at 210 (citing *Ash v. Ameritreat, Inc.*, 189 F.3d 463 (3d Cir. 1999) (holding that where employees acted without involvement by employers no fiduciary duty existed between employers and customers)).

317. Johnson, *supra* note 23 (citing *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 667 (9th Cir. 1978)).

dissent warned that respondeat superior liability may be dead,³¹⁸ there is an even greater need for an explicit cause of action.³¹⁹

The concerns voiced in *Central Bank's* dissent were not limited to respondeat superior, but warned of challenges to controlling-person liability as well.³²⁰ Even if controlling-person liability has survived, it is unclear how well it protects the interests of someone covered by an express remedy granting failure to supervise liability. Controlling-person liability contains a good faith defense,³²¹ an escape route not necessarily available under the failure to supervise rule. Controlling-person liability must be derivative and can only be brought if there is an underlying violation by a controlled person.³²² It is unclear whether such a standard exists for failure to supervise. Thus the threat of respondeat superior liability, which may have been preempted, and of controlling-person liability, which is comparatively toothless, are insufficient as deterrents to compel firm compliance with NASD supervisory rules, and thus do not preclude the need to promulgate an explicit cause of action for violation of the failure to supervise rule.³²³

c. *A Private Remedy Is Needed to Protect Investor Confidence*

Thus, without a private cause of action, the only way to enforce the NASD supervisory rules is for the SEC to bring suit. Given the aforementioned lack of funds,³²⁴ it seems foolhardy to abandon an enforcement tool deemed "essential to the maintenance of investor protection."³²⁵ No empirical data is needed to deduct that the existence of a private cause of action for failure to supervise will prompt increased supervision of brokers by the broker-dealer firms.

Without the deterrents in place there is a high risk of violations. These violations could lead to a decrease in investor confidence.³²⁶ Senators Paul S. Sarbanes, Richard H. Bryan, and Barbara Boxer, commenting on the Private Securities Litigation Reform Act of 1995, stated that "[t]he Federal securities laws generally provide for sensible regulation, and self-regulation, of exchanges, brokers, dealers and issuers," and are "the largest and most vibrant in the world," but recognized that investor confidence in the market is needed.³²⁷ "[I]nvestor confidence" is "important to . . . the

318. See *supra* notes 213-16 and accompanying text.

319. This need for the explicit cause of action is to accomplish the policy goals listed *supra* notes 311-15 and accompanying text.

320. See *supra* notes 213-16 and accompanying text.

321. See *supra* note 266 and accompanying text.

322. See *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 669 (7th Cir. 1998).

323. See *supra* notes 314-22 and accompanying text.

324. See *supra* notes 312-14 and accompanying text.

325. S. Rep. No. 104-98, at 38 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 716.

326. This would undermine the entire purpose of the Exchange Acts, enacted "[d]uring the Great Depression . . . to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation." *Id.* at 4, as reprinted in 1995 U.S.C.C.A.N. 683.

327. *Id.* at 37, as reprinted in 1995 U.S.C.C.A.N. 715.

success of our markets. . . . That confidence is maintained because investors know they have effective remedies against persons who would defraud them.”³²⁸ This acknowledgement is bipartisan: “Both Republican and Democratic Chairmen of the Securities and Exchange Commission have stressed the integral role of the private right of action in maintaining investor confidence.”³²⁹

d. Implication Bolsters the Intent Behind SROs

Some authorities assert that implying private rights of action is consistent with the intent behind the establishment of SROs.³³⁰ If the entire purpose of having SROs was to protect investors, then it makes sense to imply a private remedy because “[t]he prospect of liability would probably have a substantially greater *in terrorem* effect on members than the prospect of internal discipline.”³³¹

328. *Id.*, as reprinted in 1995 U.S.C.C.A.N. 715.

329. *Id.*, as reprinted in 1995 U.S.C.C.A.N. 715.

330. Note, *Private Actions As a Remedy For Violations of Stock Exchange Rules*, 83 Harv. L. Rev. 825 (1970) (championing implying private rights of action for violations of NASD rules that promote investor protection). The authors of the note claimed that the primary purpose of allowing a self-regulatory scheme was investor protection. *Id.* at 827. The authors considered particularly problematic that there was an “inadequacy of formal remedies for customers injured by violation of exchange rules.” *Id.* at 828-29.

331. *Id.* at 829. The Note discussed several justifications implying a private remedy. First, under a tort-negligence scheme, it makes sense that if a rule, in the court’s determination, was promulgated to protect investors, then a remedy should be implied based on negligence. *Id.* at 837. If the “risk of investor harm [was] serious enough to justify the imposition of a burden upon themselves,” then failure to adhere to the protective rule constitutes negligence of the kind to make the broker-dealer liable under tort maxims. *Id.* The problem with founding a theorem of liability on this principle is that it allows introduction of tort defenses, for example contributory negligence and assumption of risk. *Id.* at 839. This is counterproductive because “one of the purposes of the securities acts was to protect the public from its own ignorance and gullibility. It should not be open . . . to offset . . . failure to conform to the rules by pointing out that [the] customer had been negligent in” allowing the violation. *Id.* A second regimen under which liability could exist is contract law. Using the theory of an implied contract would lead to over-exclusive liability because it would encompass rules not intended to protect customers. *Id.* Using the doctrine of third-party beneficiary analysis is more appropriate to allow implication of a right. *Id.* Because SRO’s require members to obey rules, and because third-party beneficiary doctrine “requires an intention of the promisee-[SRO] to benefit the customer, these contracts will serve the dual purpose of establishing liability and limiting that liability to rules with substantive content designed for investor protection.” *Id.* at 841 (internal citations omitted). Unfortunately, a remedy based upon such a scheme could easily be subverted. *Id.* An SRO would merely have to not require members to contract to obey organization rules, or alternatively, make explicitly clear in the contracts that the promise to obey rules is not for the protection of the public and specifically exclude the public as an intended beneficiary. *Id.* In the end, the Note concluded that a remedy should be implied. *Id.*

Before a remedy can be granted, however, the court must consider the effect it will have on self-regulation. It is possible that a private remedy, by chilling the enthusiasm and prestige of the self-regulators, as well as by interfering with the congressional scheme, could do more harm than good. However, this does not appear to be a serious worry. Examination must begin with the premise that self-regulators are sincere in their desire to protect the public interest. If they are not,

e. *Recent Legislation Supports Implying a Private Right*

Proponents of implying a private right of action also turn to the recent legislation following the Enron scandal, specifically the Sarbanes-Oxley Act of 2002.³³² According to Professors Lewis D. Lowenfels and Alan R. Bromberg, the Sarbanes-Oxley Act, which includes additional supervisory requirements and directs SROs to implement them, may have opened the door for implying private actions.³³³ During the House hearings that preceded the passage of the Sarbanes-Oxley Act, several representatives “support[ed] the enhancement of the rights of private litigants to enforce the securities laws.”³³⁴ Representative Melvin Watt, in perhaps the strongest call for allowing private actions, whether through implication or explicit creation of a legal right, argued

there is a very important role for private litigants to enforce rights in this context. We can't give responsibility solely to the SEC and say you have got absolute authority to do this, and if you don't do it, then nobody is going to have the authority to do it. Our whole accountability system in this country is based on the rights of individuals to hold corporations and other individuals accountable when they feel like they have been wronged. So, at a minimum, we need to put some of those provisions in the bill to provide for private litigants to protect their own rights, and that I think is a hallmark of the way our system should work.³³⁵

Watt's statement echoes several of the policy arguments made above and shows that Congress is actively concerned about the issue of whether to allow private actions.³³⁶ Even though Watt was unable to get an explicit remedy of private action included in the Act, Lowenfels and Bromberg hypothesize that courts may imply private actions under the SRO rules that have been, or will soon be, promulgated pursuant to the Sarbanes-Oxley

there is nothing to chill and a remedy can do no harm. Similarly, it must be assumed that there will not be a disproportionately large number of successful suits. A large volume of actionable rule violations, reflecting the regulators' inability or unwillingness to make members conform to the rules, would mean that self-regulation is not doing its job of public protection, and the primacy of the public interest would demand a remedy. If, on the other hand, self-regulation does an efficient job and there are only a few violations, adverse effects on the system resulting from a judicial remedy against brokers will probably be slight. Thus, the question is whether a private remedy—and one invoked with success only infrequently—will have an undesirable effect upon a group of brokers who are making a sincere and reasonably effective effort at public protection.

Id. at 842 (footnote omitted).

332. Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

333. Lowenfels & Bromberg, *supra* note 156, at 776.

334. *Id.* at 781. Specifically supporting the enhancement or rights were Representatives John La Falce of New York, Melvin Watt of North Carolina, and Brad Sherman of California. *Id.*

335. *The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearings on H.R. 3763 Before the Comm. on Financial Services*, 107th Cong. 254 (2002).

336. *See supra* Part II.B.3.e.

Act.³³⁷ This would provide even more reason for implying a private cause of action for violation of NASD Rule 3010, a rule that was significantly affected by the Sarbanes-Oxley Act.

Additionally, at least one commentator believed that when Congress passed the Telemarketing and Consumer Fraud and Abuse Prevention Act of 1994 (“Telemarketing Act”),³³⁸ it may have created a private right of action for violation of SRO rules.³³⁹ The theory is that “[t]he Telemarketing Act’s requirement that the SEC and SRO’s promulgate rules as part of Congress’ stated intent to protect victims of telephone fraud and the SEC’s subsequent conclusion that the existing rules are sufficient to protect victims,”³⁴⁰ created a private remedy in light of section 6104 of the Act that permits a right of action by “[a]ny person adversely affected by any pattern or practice of telemarketing which violates any rule of the [Federal Trade] Commission³⁴¹ under section 6102.”³⁴²

III. THERE SHOULD NOT BE A PRIVATE REMEDY FOR INVESTORS

The reasons against implying a private right of action outweigh the reasons and policies supporting such a private right. First, there should be no private action remedy unless specifically adopted by Congress.³⁴³ There is clearly no express provision granting a private cause of action in litigation for violation of NASD Rule 3010.³⁴⁴ Thus, to argue that the remedy in litigation exists, it is necessary to imply the private cause of action.

The Supreme Court has adopted a textualist approach in implying private actions.³⁴⁵ This is justified because of the danger the Court recognized in allowing courts to interpret the reasoning and intent behind legislation—a sound policy.³⁴⁶ It is not the role of the courts to act where Congress has failed.³⁴⁷ Although courts have taken a more activist role over the years, it is Congress that has the power to create laws, not the courts, or even worse,

337. Lowenfels & Bromberg, *supra* note 156, at 805.

338. 15 U.S.C. § 6101 (2000).

339. Terrance S. DeWald & Amy B. Blumenthal, *The Telemarketing and Consumer Fraud and Abusive Prevention Act: Did Congress Create a Private Right of Action for Violation of SRO Rules?*, in Practising L. Inst., Corporate Law & Practice Course Handbook Series 241 (1998).

340. *Id.* at 243.

341. DeWald and Blumenthal argue for extending the private action from violations involving a “rule of the Commission” to “any rule promulgated . . . under Section 6102, including SEC and SRO rules.” *Id.* at 247.

342. 15 U.S.C. § 6104(a).

343. *See supra* note 183 and accompanying text.

344. *See supra* Part II.A.1.c.

345. *See supra* Part II.A.1.b-d.

346. *See supra* notes 183-85 and accompanying text.

347. *See supra* notes 232-42 and accompanying text. A Hamiltonian interpretation of Article I of the Constitution supports this proposition. *See supra* notes 233-43 and accompanying text.

arbitrators.³⁴⁸ Since, when applying a strict textualist approach, there is no basis for implying a private remedy for violation of the failure to supervise rule,³⁴⁹ one should not be implied.

Even abandoning the strict textualist approach that the Supreme Court has used for over twenty-five years and turning to the legislative history and congressional intent, there is not a sufficient basis for implying a cause of action.³⁵⁰ Although the legislative histories include discussion of creating such a remedy,³⁵¹ the final versions of securities bills fail to include a private remedy.³⁵² This was not mere oversight, for Congress has had many opportunities to enact explicit legislation creating a private cause of action.³⁵³ The issues were discussed and eventually tabled or rejected.³⁵⁴ If Congress intended for the right to exist it would have been forthright and explicit.³⁵⁵ “[F]ailed legislative proposals are ‘a particularly dangerous ground on which to rest an interpretation of a prior statute.’”³⁵⁶

This argument is particularly persuasive when applied to failure to supervise claims. If Congress decided not to create an express provision allowing private actions to be brought for aiding and abetting,³⁵⁷ a cause of action that had traditionally been allowed due to the threat of increased frivolous litigation,³⁵⁸ then Congress would not have intended to create a cause of action for violation of the failure to supervise rule, an NASD rule that is only tangentially related to the 1934 Act and that has not enjoyed the same widespread traditional protections as aiding and abetting.³⁵⁹ The threat of meretricious litigation is as potent with regard to failure to supervise claims as it is to aiding and abetting claims.³⁶⁰ Thus, if Congress was unwilling to create a private cause of action for aiding and abetting for reasons that are equally applicable to failure to supervise claims, then prevailing policy dictates that the private action does not exist, should not exist, and certainly should not be implied by the courts.

The courts have held that failure to supervise is an arbitrable issue under NASD Rule 10301.³⁶¹ This has the effect of creating a private cause of action in arbitration for failure to supervise and leads to tension between the

348. See *supra* notes 232-42 and accompanying text. President Bush has made his stance on judicial activism clear. See *supra* note 233. His stance on arbitrator activism would likely be equivalent. Cf. *supra* note 233 (finding the threat of judicial activists severe enough to advocate passage of an amendment).

349. See *supra* notes 189-207 and accompanying text.

350. See *supra* Part II.A.1.

351. See *supra* note 252 and accompanying text.

352. See *supra* notes 252-53 and accompanying text.

353. See *supra* notes 252-53 and accompanying text.

354. See *supra* notes 252-53 and accompanying text.

355. See *supra* note 206 and accompanying text.

356. *Cent. Bank v. First Interstate Bank*, 511 U.S. 164, 187 (1994) (quoting *Pension Benefit Guaranty Corp. v. LTV Corp.*, 496 U.S. 633, 650 (1990)).

357. See *supra* notes 208-17 and accompanying text.

358. See *supra* notes 243-53 and accompanying text.

359. See *supra* notes 208-17 and accompanying text.

360. See *supra* notes 252-53 and accompanying text.

361. See *supra* note 144.

outcome of decisions in arbitrations and the outcome in courts. A better rule would limit the ability to recover using language employed by NASD Rule 10214, the provision describing arbitration awards in employment discrimination disputes.³⁶² Under this rule, “arbitrator(s) shall be empowered to award any relief that would be available in court under the law.”³⁶³ With such a rule in place, arbitrators would be unable to hear claims that have been barred from courts, like private causes of action for violation of the failure to supervise rule, which would harmonize the law regardless of the venue used to bring forth such claims.

Aside from the desire to integrate the law of arbitration with the law of litigation, policy dictates that a private remedy should not exist. The policy reasons for implying a private remedy are not compelling. There are sufficient deterrents in place that can provide protection for investors under the current regulatory system, even if harmed investors cannot recoup damages.³⁶⁴ The SEC brings disciplinary actions and assesses large fines for violations of the supervisory rules.³⁶⁵ In most states there are other methods by which a harmed investor can recover for rightful claims against the broker-dealer.³⁶⁶ If the harm occurred under the direction of the broker-dealer, recovery will be allowed under controlling-person liability.³⁶⁷ Blue-sky laws also allow the theory of respondeat superior and possibly conspiracy and aiding and abetting.³⁶⁸ Thus, a harmed investor already has sufficient options.

Allowing the claims to be brought will have an adverse effect on the broker-dealer industry.³⁶⁹ The high costs of litigation and arbitration drive many broker-dealers to settlements—even when the lawsuits are frivolous.³⁷⁰ The threat of becoming entrenched in costly and protracted disputes is great, unless these claims are dismissed on a procedural ground.³⁷¹ Even the cost of adhering to the tenets of the NASD Discovery Guide can be unduly burdensome. These costs are then capitalized by broker-dealers into the costs of investing, thus creating a bar to the market.³⁷² Therefore, attempting to stimulate investment by championing investor protection and building investor confidence is

362. NASD, Inc., Rule of Procedure 10214.

363. *Id.*

364. *See supra* notes 254-67 and accompanying text.

365. *See supra* notes 35-36.

366. *See supra* notes 254-67 and accompanying text; *see also, e.g.*, Fla. Stat. § 517.211 (2004) (allowing private remedy for control person liability); Tex. Rev. Civ. Stat. Ann. art. 581-33(A) (2004) (same); Utah Code Ann. § 61-1-1 (2004) (same); Va. Code Ann. § 13.1-522(C) (2004) (providing for control person liability for violations of Va. Code Ann. § 13.1-522(A)).

367. *See supra* notes 260-67 and accompanying text.

368. *See supra* notes 254-67 and accompanying text.

369. *See supra* notes 246-47 and accompanying text.

370. *See supra* notes 246-47 and accompanying text.

371. *See supra* notes 246-47 and accompanying text.

372. *See supra* notes 246-47 and accompanying text.

counterproductive.³⁷³ The reality is that a private remedy would merely raise costs without truly adding any layer of protection.³⁷⁴

Although investors have been clamoring for increased protections in the wake of recent accounting scandals,³⁷⁵ Congress should restrain from passing knee-jerk legislation that sweeps too broadly, ensnaring broker-dealers in a wide net, and rather should limit such laws to their true purpose—ensuring that companies report accurately.³⁷⁶

In order to ensure that arbitrators do not mistakenly award judgments on failure to supervise, the claim should be barred from arbitration entirely. Rather than allow the arbitrators to decide if the issue is arbitrable, the SEC and NASD should promulgate rules that will not allow a dispute to go to arbitration if it is based on a failure to supervise claim. Barring certain claims from arbitration is not a novel idea.³⁷⁷ The NASD already bars class action suits from arbitration.³⁷⁸ Barring failure to supervise claims will reduce frivolous lawsuits and reestablish the SEC as the sole defender of violations of exchange and SRO rules.

Unfortunately, it seems unlikely that the SEC will take such a bold step.³⁷⁹ Since barring the claims seems unlikely, the NASD could take the smaller step of requiring arbitrators to list the reasons for granting the award. This is not entirely novel, as the rules governing employment discrimination claims already require arbitrators to “set[] forth a summary of the issues, including the type(s) of dispute(s), the damages or other relief requested and awarded, a statement of any other issues resolved, and a statement regarding the disposition of any statutory claim(s).”³⁸⁰ Thus, if arbitrators rely on the failure to supervise claim exclusively, a defendant will at least have cause to vacate the award. Instead, it seems likely that this legal quagmire will remain. The Supreme Court and Congress will remain disinclined to imply a private right of action for NASD rule violations. The NASD will allow claims in arbitration. Arbitrators will continue to arbitrarily decide whether to dismiss failure to supervise claims and plaintiffs will continue filing frivolous claims that grant them discovery

373. See *supra* notes 243-53 and accompanying text.

374. See *supra* notes 243-53 and accompanying text.

375. See *supra* notes 268-71 and accompanying text.

376. The Sarbanes-Oxley Act of 2002 is defined as an act “[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.” 107 Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

377. NASD, Inc., Rule of Procedure 10301 (2001).

378. *Id.*

379. In an age of heightened investor concern following the recent Wall Street scandals and with increased clamoring for added investor protection, it is unlikely that the SEC will take an action that may be perceived by laymen as limiting investors’ rights. For a detailed look at the heightened concerns of the public and the reasons behind them, see Douglas L. Keene & Rita R. Handrich, *The Enron Effect: Uncertainty, Mistrust, and Cynicism, in Advocacy Track: Communicating with the Jury—Repackaging Your Message* (Ass’n of Trial Lawyers of Am. 2003).

380. NASD, Inc., Rule of Procedure 10214.

in both arbitration and litigation. The day of a tribunal of nonlegal practitioners and SRO opinions trumping our most sacred Court and Congress is upon us. Be afraid.

Notes & Observations