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# An Implied Private Right of Action under Section 16(a) of the Securities Exchange Act of 1934

Robert N. Rapp

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## NOTES

### *An Implied Private Right of Action Under Section 16(a) of the Securities Exchange Act of 1934*

*Judicial implication of private rights of action from federal securities legislation has been hailed as a major step toward meaningful regulation of securities practices and market stability. This Note examines a recent extension of implied liability under a provision not previously considered supportive of such a right. After attempting to develop a workable rationale for the private right, the author concludes that the extension cannot be supported and that the court should have taken heed of the cautiousness exhibited by other courts and refused to extend implied liability to situations not clearly within the intended protective scheme of the legislation.*

#### I. INTRODUCTION

THE SECURITIES EXCHANGE ACT of 1934<sup>1</sup> constitutes part of the federal plan to regulate interstate traffic in investment securities. The Act aims at the elimination of deceptive and manipulative practices in the securities markets by affording securities investors a measure of disclosure and remedies for fraudulent trading.<sup>2</sup>

Section 16(a) of the 1934 Act is an integral part of the protective plan. It requires a report from every person who is an officer or director of a company with an equity security listed on a national exchange, or who is directly or indirectly the beneficial owner of more than ten percent of such a security. The individual must file an initial report of his holdings in all of the company's equity securities and a further report if there is any change in the extent of those holdings. In all cases, these reports must be filed with both the Securities Exchange Commission and with the stock exchange upon which the security is listed.<sup>3</sup> The information obtained through the

<sup>1</sup> 15 U.S.C. § 78 (1970).

<sup>2</sup> H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934); 1 L. LOSS, SECURITIES REGULATION 130-31 (1961).

<sup>3</sup> 15 U.S.C. § 78p(a) (1970). Section 16(a) provides:

Every person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempt security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange, or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director or officer, a statement

required reports is then made public by the Commission and the individual exchanges.<sup>4</sup>

The avowed congressional purpose of the reporting requirement of section 16(a) was to control unfair insider use of information not publicly available. Prior to the passage of the Securities Exchange Act of 1934, insiders had often used such information for their personal advantage.<sup>5</sup> Congress believed this mandatory reporting requirement would bring abusive insider practices into disrepute and thereby encourage the voluntary maintenance of proper fiduciary standards.<sup>6</sup> Section 16(a) at one time also had the additional, though subsidiary purpose of *informing prospective investors* of insider purchases and sales because such transactions are considered good evidence of an insider's estimation of company prospects.<sup>7</sup>

Section 16(a), however, does not contain an express provision to enforce the reporting requirement. The absence of such a provision has led some commentators to read the section in conjunction with section 16(b), which provides a remedy to an issuing corporation whose equity securities have been traded at a profit by an insider.<sup>8</sup> Authorities embracing this view submit that the two sections taken together represent a complete statutory scheme and that

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with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter if there has been a change in such ownership during such month, shall file with the Commission (and, if such security is registered on a national exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

<sup>4</sup> The Securities Exchange Commission publishes the information in monthly pamphlets which receive wide distribution. See SEC, OFFICIAL SUMMARY OF SECURITY TRANSACTIONS AND HOLDINGS OF OFFICERS, DIRECTORS AND PRINCIPAL SHAREHOLDERS.

<sup>5</sup> The committee's report concerning the bill described one such incident: "The president of a corporation testified that he and his brothers controlled the company with a little over 10 percent of the shares; that shortly before the company passed a dividend, they disposed of their holdings for upward of \$16,000,000 and later repurchased them for about \$7,000,000 showing a profit of \$9,000,000 . . ." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934).

<sup>6</sup> H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934).

<sup>7</sup> *Id.* at 24.

<sup>8</sup> 15 U.S.C. § 78p(b) (1970).

Section 16(b) creates a cause of action for recovery by the issuing corporation, or a shareholder on behalf of the issuing corporation, of any profit realized by an insider (officer, director or beneficial owner of more than ten percent of the outstanding shares in the issuing corporation) on the purchase and sale or sale and purchase of any security of the issuer within a period of less than six months. Except for a good faith acquisition of the shares in connection with a previously contracted debt, the section operates irrespective of any intent on the part of an insider to hold or not repurchase the security within the six month period.

no additional remedy under 16(a) is necessary to control abusive insider practices.<sup>9</sup> The recent case of *Grow Chemical Corporation v. Uran*,<sup>10</sup> however, held that an implied private right of action existed for the enforcement of section 16(a). In *Grow Chemical* the plaintiff corporation had purchased shares of the Guardsman Chemical Corporation at a premium, with an eye toward possible merger. Before purchasing the shares, the plaintiff examined files of the Securities Exchange Commission to determine whether any individual was the beneficial owner of more than 10 percent of Guardsman's outstanding shares. The Commission files showed no one owning more than 10 percent. In fact, however, the defendant owned 13 percent of the shares but had failed to report his holdings as required by section 16(a). The plaintiff alleged that it had paid a considerably higher price for the shares than it would have, had the extent of the defendant's holdings been known. The district court refused to dismiss the plaintiff's damage action for violation of the reporting requirement.<sup>11</sup>

Although *express* private rights of action are provided for in some provisions of the 1934 Act,<sup>12</sup> courts have allowed implied private rights of action for the enforcement of provisions of the Act which make no mention of such private rights. Most notably, implied private rights have been recognized under section 10(b),<sup>13</sup> the general anti-fraud section, and section 14(a),<sup>14</sup> the proxy regulations. In addition to these sections, private rights have been upheld under sections 6(b),<sup>15</sup> 7<sup>16</sup> and 13(d),<sup>17</sup> and also under section 17(a) of the Securities Act of 1933.<sup>18</sup>

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<sup>9</sup> See *Robbins v. Banner Industries*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,861 at 95,950 (S.D.N.Y. 1966). The court in *Robbins* observed that an insider's failure to file timely notice of his purchase of securities, a violation of section 16(a), did not bring him within the class of defendants contemplated by section 16(b). Consequently, section 16(b) was the only available remedy.

<sup>10</sup> [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,688 at 99,021 (S.D. N.Y. 1970).

<sup>11</sup> The *Grow Chemical* decision was founded upon a motion to dismiss. No subsequent history of the case has been reported.

<sup>12</sup> See 15 U.S.C. §§ 78i(e), 78p(b), 78r, 78cc (1970). These sections provide, *inter alia*, for causes of action for those persons who purchase or sell securities at a price affected by manipulative practices, for those victimized by false or misleading statements or representations in a transaction covered by the Act, and for the voiding of any contract made in violation of the Act or rules thereunder.

<sup>13</sup> 15 U.S.C. § 78j(b) (1970). Section 10(b) declares that it shall be unlawful to employ manipulative or deceptive devices in the purchase or sale of equity securities.

<sup>14</sup> 15 U.S.C. § 78n(a) (1970). Section 14(a) prohibits the solicitation of proxies in contravention of any rules or regulations prescribed by the Securities Exchange Commission as necessary for the protection of investors.

<sup>15</sup> 15 U.S.C. § 78f(b) (1970). Section 6(b) provides for the expulsion, suspension

*Grow Chemical* is the first case to expressly recognize an implied private right of action under section 16(a).<sup>19</sup> While the issue has been raised in several other situations, the 16(a) implied private right has either been denied or hidden under broader rationales.<sup>20</sup> This Note will examine the propriety and justification for the result in *Grow Chemical*.

## II. CREATION OF IMPLIED PRIVATE RIGHTS OF ACTION UNDER FEDERAL SECURITIES LEGISLATION

In the two most significant instances of implied private rights of action under the federal securities laws,<sup>21</sup> the courts have enunciated three separate rationales to justify the implication of private rights. The most often utilized rationale, generally characterized as the "statutory tort" theory, is founded in the common law process of tort creation and reasons that the violation of a statutory command

or disciplining of a member of a national securities exchange for conduct inconsistent with equitable principles of trade or willful violations of the Act. A private right of action for enforcement of the section was recognized in *Baird v. Franklin*, 141 F.2d 238, 244-45 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944). The court observed that if the investing public is to be completely and effectively protected, section 6(b) must be construed as granting individual rights of action to enforce the statutory duties.

<sup>16</sup> 15 U.S.C. § 78g (1970). Section 7 outlines margin requirements for the purchase of securities. An implied private right of action under this section was recognized in *Reader v. Hirsch*, 197 F. Supp. 111 (S.D.N.Y. 1961), where the court allowed recovery of losses suffered in securities transactions arranged by a brokerage firm in violation of the margin requirements. See also *Remar v. Clayton Securities*, 81 F. Supp. 1014 (D. Mass. 1949).

<sup>17</sup> 15 U.S.C. § 78m(d) (1970). Section 13(d) requires the submission of periodic reports, similar in substance to those required by section 16(a), by individuals engaged in a corporate acquisition. A private right of action for the enforcement of section 13(d) was upheld in *Bath Industries v. Blot*, 305 F. Supp. 526 (D. Wis. 1969).

<sup>18</sup> 15 U.S.C. § 77q(a) (1970). Section 17(a) is part of the general anti-fraud scheme of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970). That section declares that it shall be unlawful for any person in the offer or sale of securities to employ devices or schemes to defraud, or obtain money by means of false or misleading statements, or generally engage in any course of conduct which would operate as a fraud or deceit upon anyone purchasing securities. A private right of action to effectuate the provision was recognized in *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955).

<sup>19</sup> An earlier consideration of the question was undertaken in *Kroese v. Crawford*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. §91,473 at 94,196 (S.D.N.Y. 1963). In that case, beneficiaries of a business trust alleged, *inter alia*, that the defendants (trustees) had failed to file insiders' reports as required by section 16(a). The court reacted favorably to the plaintiffs' claim and denied the defendants' motion to dismiss, noting that a private right of action should exist where a plaintiff is in fact protected by a legislative provision. The court did *not* declare that the particular plaintiffs in *Kroese* were protected by section 16(a). Instead the court characterized that question as one of fact to be considered at a later time.

<sup>20</sup> See notes 52-65 *infra* and accompanying text.

<sup>21</sup> These instances involved sections 10(b) and 14(a) of the 1934 Act.

is a wrong in itself so that liability follows whenever the prohibited conduct injures a party whom the statute was designed to protect. A private right of action under this theory is necessarily premised upon the lack of an effective common law or statutory remedy. A second rationale allows implied private rights of action when necessary to implement the dominant congressional purpose of a particular statute. This theory is predicated on both the existence of a statute with a clearly expressed intention and the presupposition that the statute's *express* remedies are inadequate. Finally, implied private rights of action have been permitted on the basis of a jurisdictional grant in a particular act. These courts have held that the grant of jurisdiction includes the concomitant power to make jurisdiction *effective*.<sup>22</sup>

The foundation for the statutory tort rationale is section 286 of the *Restatement of Torts*. That section states that a civil suit for violation of a legislative enactment is proper, provided that such enactment was intended to prevent the type of injury which occurred and to protect the particular plaintiff alleging the measure's violation.<sup>23</sup> *Restatement* section 286 became the initial basis for an implied private right of action under the Securities Exchange Act in the 1946 case of *Kardon v. National Gypsum*.<sup>24</sup> In the years preceding *Kardon*, it had become apparent that the anti-fraud provisions of section 10(b) of the Act<sup>25</sup> and Commission rule 10b-5<sup>26</sup> could have little meaningful significance as protective devices without a private right of enforcement, particularly since none of the available Commission sanctions was compensatory in nature.<sup>27</sup> The court in *Kar-*

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<sup>22</sup> See *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Deckert v. Independent Shares Corp.*, 311 U.S. 282 (1940).

<sup>23</sup> See 2 RESTATEMENT OF TORTS § 286 (1938).

An alternative view would urge that a suit be allowed only in those cases where it is thought that the legislature would have provided such a right had it considered the issue. This approach has been criticized as dangerous speculation into unexpressed legislative intent. See Thayer, *Public Wrong and Private Actions*, 27 HARV. L. REV. 317, 320 (1914).

<sup>24</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>25</sup> 15 U.S.C. § 78j(b) (1970). See note 13 *supra*.

<sup>26</sup> 17 C.F.R. 240.10b-5 (1964). SEC Rule 10b-5 was promulgated in 1942 pursuant to the authorization found in section 10 of the 1934 Act. It states that it shall be unlawful for any person to employ in connection with the purchase or sale of any security registered on a national securities exchange, any manipulative or deceptive device or contrivance. For an analysis of the background and utility of Rule 10b-5 see Sommer, *Rule 10b-5: Notes for Legislation*, 17 CASE W. RES. L. REV. 1029 (1966).

<sup>27</sup> Under provisions of 1934 Act, government sanctions are limited to:

- (a) Disciplining broker-dealers;
- (b) Criminal prosecution of violators; and
- (c) Injunctive relief from continued or future violations.

*don* viewed section 10(b) and Rule 10b-5 as establishing a standard of conduct. Citing the *Restatement*, Judge Kirkpatrick declared that a court may create a cause of action for violation of a statutory provision if the statute provides that particular acts shall or shall not be done.<sup>28</sup> The only prerequisite to application of the "statutory tort" approach to securities violations is meeting the mechanical requirements of *Restatement* section 286.

When the statutory tort rationale is used to imply a private right of action, an injured party is afforded the full range of compensatory relief because the wrongdoer is liable for any injury proximately caused by his misconduct. The inclusion of compensatory relief for injured plaintiffs gives section 10(b) and Rule 10b-5 a truly protective posture.

The "congressional purpose" rationale for implied private rights of action was enunciated by the United States Supreme Court in the 1964 case of *J.I. Case Co. v. Borak*.<sup>29</sup> The Court recognized

*See* 15 U.S.C. §§ 78f(b), 78u(e), 78ff (1970). For a discussion of the statutory limitations upon Commission action and its impact upon securities transactions see A. BROMBERG, *SECURITIES LAW: FRAUD — SEC RULE 10b-5* 46-47 (1969). The criminal sanctions available under the Act are discussed in Herlunds, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139 (1934); Note, *SEC Actions Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769 (1946).

<sup>28</sup> 69 F. Supp. at 513. *Kardon* was decided under section 286 of the *Restatement* which provided that an individual who violated a legislative enactment was liable for invading the interest of another if four conditions were met:

- (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and,
- (b) the interest invaded is one which the enactment is intended to protect; and,
- (c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests results from the hazard; and,
- (d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action. RESTATEMENT OF TORTS § 286 (1934).

In 1964, *Restatement (Second) of Torts* superseded the earlier *Restatement of Torts*. New section 286 provides:

The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part

- (a) to protect a class of persons which includes the one whose interest is invaded, and
- (b) to protect the particular interest which is invaded, and
- (c) to protect that interest against the kind of harm which has resulted, and
- (d) to protect that interest against the particular hazard from which the harm results. RESTATEMENT (SECOND) OF TORTS § 286 (1965).

Other than authorizing the reasonable man standard, the scope of both versions of section 286 remains substantially the same. Therefore, though the *Kardon* reasoning involved the earlier *Restatement* it should be equally applicable under section 286 of *Restatement (Second) of Torts*.

<sup>29</sup> 377 U.S. 426, 431-33 (1964).

an implied private right of action to enforce section 14(a) of the 1934 Act,<sup>30</sup> which prohibits the solicitation of proxies in contravention of any rules or regulations prescribed by the Securities Exchange Commission. In *Borak* the Court observed that the protection of investors was chief among the purposes of the section, even though neither section 14(a), nor the corresponding Commission Rule 14a-9, made specific reference to a private right of enforcement. To achieve this purpose an implied private right, according to the Court, is an absolute necessity.<sup>31</sup>

In implementing Congress's protective purpose, the *Borak* decision discussed an earlier analysis by the Court<sup>32</sup> to the effect that federal courts must: (1) construe the details of an act in conformity with its dominant general purpose; (2) read the text in the light of context; and (3) interpret the meaning of words so as to carry out the generally expressed legislative purpose in any particular case.<sup>33</sup> *Borak* reaffirmed this earlier analysis and imposed a clear duty upon federal courts to provide the remedies necessary to make effective the congressional purpose of a statute.<sup>34</sup>

The third rationale for the implication of private rights of action, also relied upon in *Borak*, is the general jurisdictional grant to courts found in section 27 of the Act.<sup>35</sup> This section creates jurisdiction in the district courts over all suits brought to enforce liabilities and duties created by the Act. Even before *Borak*, however, a jurisdictional grant had been used to fashion a new remedy. In an earlier decision involving a jurisdictional grant in the Securities Act of 1933,<sup>36</sup> which was virtually identical to section 27, the Court declared:

The power to enforce implies the power to make effective the right of recovery afforded by the act. And this power to make the right of recovery effective implies the power to utilize any of

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<sup>30</sup> 15 U.S.C. § 78n(a) (1970).

<sup>31</sup> Speaking for the majority, Mr. Justice Clark observed that a private right of action under section 14(a) provides a necessary supplement to Commission action, since the Commission could not have time to make an independent examination of the facts set out in each proxy statement submitted. 377 U.S. at 432-33.

<sup>32</sup> SEC v. C. M. Joiner Corp., 320 U.S. 344 (1943).

<sup>33</sup> *Id.* at 350-51.

<sup>34</sup> See *J. I. Case Co. v. Borak*, 377 U.S. 426, 430 (1964).

<sup>35</sup> 15 U.S.C. § 78aa (1970). Section 27 provides:

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

<sup>36</sup> 15 U.S.C. § 77v (1970).



the procedures or actions normally available to the litigant according to the exigencies of a particular case.<sup>37</sup>

The Court found the words of the jurisdictional grant sufficient to create an equitable remedy for rescission of a fraudulent sale, a remedy not authorized by the Act.

Clearly the effect of the jurisdictional grant, statutory tort, and congressional purpose rationales is to create a new liability, and thus a new remedy, where none previously existed. Some commentators have criticized the jurisdictional grant argument for this reason. They point out that it is extremely difficult, if not impossible, to ascertain how authorization to enforce an *existing* liability or to implement an *existing* remedy can support the creation of new implied liabilities or remedies.<sup>38</sup> Specific jurisdictional grants in federal statutes have traditionally been narrowly interpreted. Courts have analyzed them to determine whether Congress intended the federal courts to have exclusive or concurrent jurisdiction (with state courts) over actions arising under a specific statute.<sup>39</sup> Given this narrow interpretation, federal courts have jurisdiction to determine whether a private right of action should exist, but such a right need not be the automatic result. This conclusion was underscored in the case of *Wheedlin v. Wheeler*<sup>40</sup> where the Supreme Court declared that some affirmative congressional intent was a prerequisite to the creation of private rights of action for violation of federal statutes.<sup>41</sup> Thus, an exclusive grant of jurisdiction to enforce liabilities and duties created by a statute does not of itself support the creation of new liabilities and duties.

The viability of using the section 27 jurisdictional grant rationale as the sole basis for the implication of a private right of action is left in serious doubt by *Wheedlin*. Moreover, the *Borak* majority's emphasis on the existence of a dominant congressional purpose as an

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<sup>37</sup> *Deckert v. Independent Shares Corp.*, 311 U.S. 282, 288 (1940). In *Deckert* the Court was confronted with the question of whether the Securities Act of 1933 authorized a purchaser of securities to sue for rescission of a fraudulent sale.

For a similar, but even broader use of a jurisdictional grant, see *Textile Workers Union v. Lincoln Mills*, 353 U.S. 448 (1956). In *Lincoln Mills*, section 301 (a jurisdictional provision) of the Labor Management Relations Act was used as the authorization to create a federal common law of contracts to govern labor situations.

<sup>38</sup> See Note, *Private Rights From Federal Statutes: Toward a Rational Use of Borak*, 63 NW. U.L. REV. 454, 455 (1968).

<sup>39</sup> See, e.g., *Lockerty v. Phillips*, 319 U.S. 182, 188 (1943).

<sup>40</sup> 373 U.S. 647 (1963). In *Wheedlin*, petitioner claimed that a subpoena ordering him to appear before a congressional committee had been issued in violation of the enabling resolution.

<sup>41</sup> *Id.* at 650.

alternative approach failed to add credibility to the section 27 rationale. And since a clear congressional purpose is alone sufficient to imply a private right of action,<sup>42</sup> the use of section 27 becomes superfluous.

Close analysis of the two effective theories for implying private rights of action (*i.e.*, the statutory tort and congressional purpose rationales) shows that the class of persons entitled to raise such rights is the same under either approach.<sup>43</sup> The proscription of certain conduct by Congress necessarily reflects the intention to protect the class of persons potentially subject to injury by the wrongful conduct. Utilizing either rationale a plaintiff must demonstrate that he is, in fact, protected by the provision involved. While under the statutory tort approach the language of a pleading must be more precise and mechanical in order to satisfy the express requirements of *Restatement (Second)* section 286,<sup>44</sup> the net effect of the words is to declare that the congressional purpose of the act, to protect an individual interest, is thwarted by its violation. Under either approach, the reasoning process differs only in form and remains the same in substance.<sup>45</sup> The end result in either case is that an implied private right exists in favor of any member of the class which the particular provision was intended to protect.

Given the absence of any meaningful difference between the two viable rationales for implied private rights of action, the prime inquiry into the existence or non-existence of such a right should focus upon: (1) the nature of the provision under which a private right is asserted to determine whether it has a protective purpose; and (2) who is to be protected by that provision. Of course, should it be concluded that a particular provision is not protective, or, if pro-

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<sup>42</sup> See notes 29-34 *supra* & accompanying text.

<sup>43</sup> Theoretically there is, of course, a major distinction between the two in terms of available relief. Common law tort theory provides that compensatory relief shall be available for all damages proximately caused by a tortious act. The congressional purpose rationale offers no such scheme of relief, and there remains the possibility that a court may formulate a scheme of relief unfamiliar to tort law, even though parallel reasoning seems most likely to be applied.

<sup>44</sup> See note 28 *supra* & accompanying text.

<sup>45</sup> To support a private right of action under *Restatement (Second) of Torts* section 286, the plaintiff, the particular interest, the resulting harm to that interest, and the hazard creating the harm must be protected by the provision whose violation the plaintiff raises. In its simplest terms the analysis concludes that the plaintiff is protected against a particular harm.

Under the congressional purpose rationale the inquiry is virtually identical. One must conclude that Congress did intend to protect someone by a particular legislative provision. Once that protective purpose is established, a protected class of persons may be identified. One who falls within that class would then be entitled to raise a private right of action for violation of the provision.

tective, that the individual asserting its violation is not within the class to be protected, then neither rationale can be invoked to support an implied private right. Thus, to ascertain whether or not a private right of action is justified under section 16(a) of the Securities Exchange Act, it is first necessary to determine who, if anyone, is protected by the section.<sup>46</sup> In order to decide who is protected by section 16(a), the intent of the section must be determined.

### III. THE NATURE OF SECTION 16(a)

Congressional history evidences two purposes for section 16(a). First, Congress asserted that the provision would curb abusive insider practices by discouraging the rampant use of inside information for personal advantage. Legislators believed that full and prompt publicity of insider transactions would promote self-discipline among insiders.<sup>47</sup> The second, but less apparent, express purpose of the section was to provide investors with information concerning purchases and sales by corporate insiders. Congress anticipated that this information would allow present and prospective investors to make more judicious financial decisions.<sup>48</sup> Control of insider abuse was, however, clearly uppermost in the minds of the Congressmen. Not only did the "control of insider abuse" aspect of the provision receive special analysis in the House report, but discussion of the availability of reliable information for investors was omitted from the Senate report.<sup>49</sup>

Although the congressional history seems to support two purposes, commentary on section 16(a) uniformly maintains that the section is directed entirely at the control of abusive practices by corporate insiders.<sup>50</sup> If control of these practices through disclosure of insider trading is the sole purpose of the section, then the persons to be protected by it are those who stand to be injured by these abusive practices. Clearly this group would include the corporation and its shareholders (prospective and present) who trade with in-

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<sup>46</sup> Apparently the plaintiff in *Grow Chemical* alleged that it was protected by section 16(a) since the defendant, in his motion to dismiss, averred that the plaintiff was *not* protected and could not raise a violation of the requirement.

<sup>47</sup> See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934); see also H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 26 (1966); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385 (1953).

<sup>48</sup> H.R. REP. NO. 1383, 73d Cong., 2d Sess. 24 (1934).

<sup>49</sup> See S. REP. NO. 792, 73d Cong., 2d Sess. (1934).

<sup>50</sup> See 2 L. LOSS, *supra* note 2, at 1038-40; H. MANNE, *supra* note 47; Cook & Feldman, *supra* note 47; Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947).

siders, but it is difficult to foresee anyone else within the protected class. A prospective investor or an acquiring corporation, as in the case of *Grow Chemical*, could not suffer from insider trading abuses unless it bought from an insider or until it became a shareholder of a corporation whose insiders were trading with others. Thus, if insider trading abuses are the only concern of section 16(a), *Grow Chemical*, which neither purchased from an insider nor (from the facts that appear) was a shareholder of *Guardsman* at the time *Uran* was trading, would not be in the "protected group." At best, any possible benefit to prospective investors from enforcement of the reporting requirements is indirect.<sup>51</sup>

Judicial interpretation of section 16(a) largely embraces the commentators' conclusion that the section was not intended to benefit investors generally but rather to curb insider abuse. In *Grossman v. Young*<sup>52</sup> the question concerning the protective nature of section 16(a) was met squarely. In *Grossman* an insider's failure to file reports as required by 16(a) tolled the statute of limitations for an action subsequently commenced under section 16(b).<sup>53</sup> The court denied a private right of action for enforcement of the reporting requirement, declaring that the principle purpose of section 16(a) was to provide a basis for actions instituted under section 16(b), and that 16(b) constituted the only civil remedy available.<sup>54</sup> An identical approach to 16(a) was taken in the cases of *Robbins v. Banner Industries*<sup>55</sup> and *Rogers v. Valentine*.<sup>56</sup> Just as in *Grossman*, the

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<sup>51</sup> If, for example, an investor learns of an impending suit to recover profits made by an insider acting in violation of the reporting requirement and knowledge of that suit is public, a subsequent investment in the corporation would reap a share of those recovered profits.

There remains a further interesting possibility for indirect benefit to an investing or acquiring corporation from enforcement of the reporting requirement. It is conceivable that an investing corporation may fail to exercise its "corporate opportunity" to acquire shares of another corporation as a result of abusive insider practices within the other corporation which have presented a less attractive financial picture of that corporation. Enforcement of the reporting requirement, on the other hand, would presumably curb or eliminate insider abuse in the target corporation thereby promoting a more accurate, and possibly more attractive financial picture upon which the acquiring corporation could evaluate its action.

<sup>52</sup> 72 F. Supp. 375 (1947).

<sup>53</sup> Section 16(b) provides that any suit to recover insiders' profits must be brought within two years after the date such profit was realized. In *Grossman* the insider's failure to comply with the section 16(a) reporting requirement prevented discovery of the realization of those profits until after the two year period had lapsed.

<sup>54</sup> 72 F. Supp. at 378.

<sup>55</sup> [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. §91,861 at 95,950 (S.D. N.Y. 1966). In *Robbins* part of a stockholders' derivative action alleged the failure of the defendant to file statements of beneficial ownership as required by section 16(a). *Id.* at 95,952.

*Robbins* and *Rogers* courts observed that section 16(a) was directed solely at the control of insider abusive practices for which section 16(b) provides the exclusive (and presumably adequate) remedy.

*Grossman*, *Robbins* and *Rogers* narrowly interpret section 16(a), emphasizing the conjunctive nature of 16(a) and 16(b). If the position of those courts were controlling, a forceful argument could be made that an investor who relied on section 16(a) reports for the purpose of determining whether insiders are invested in the issuer would not be protected, even though section 16(a) does create a protected class (containing present shareholders and the corporation itself). Such an investor would not, therefore, have a private right of action under either the statutory tort or congressional purpose rationales.

But the *Grossman* approach to section 16(a) is not the sole case authority. In *Chicago South Shore R.R. v. Monan R.R.*<sup>57</sup> a railroad targeted for acquisition filed for injunctive relief to restrain further purchases of its stock by another railroad. The action was grounded upon the acquiring railroad's failure to file notice of a change in beneficial ownership of the target railroad's shares, a violation of section 16(a). The district court accepted jurisdiction over the claim and noted that a private right of action should exist for enforcement of section 16(a) in some circumstances, since violation of that section might lead to considerable investor injury as a result of unknown insider trading or misevaluation of company prospects.<sup>58</sup> The court declared that section 16(a) represented more than a mere administrative provision to bolster the express remedy of section 16(b) for consummated insider trading, and that it served the additional function of (1) letting the public know what insiders think of the issue as an investment, and (2) allowing the public to protect itself *in advance* against insider trading.

*Grow Chemical* differs markedly from the *Chicago South Shore* situation. In *Chicago South Shore*, the corporation itself sued rather than an investor. Additionally, equitable relief was sought as opposed to compensatory damages. Nevertheless, the controlling prin-

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<sup>56</sup> [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. §91,473 at 94,822 (S.D.N.Y. 1964). In *Rogers* the defendant purchased and sold securities without recording the extent of his holdings within the required time period, pursuant to section 16(a). Summary judgment for the defendant was granted despite the clear violation of section 16(a).

<sup>57</sup> [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. §91,525 at 94,977 (N.D. Ill. 1965).

<sup>58</sup> *Id.* at 94,978.

ciple in *Chicago South Shore* — that section 16(a) is in fact a provision protecting investors — might be extended to *Grow Chemical* since it is implicit in *Grow Chemical* that the plaintiff evaluated the propriety of an investment decision at least partially upon the basis of information obtained through section 16(a) reports. In addition, the plaintiff in *Grow Chemical* paid a premium on the acquired stock which would not have been paid had the ownership reports been complete.

Whether the resulting injury in *Grow Chemical* is the same as that contemplated by the court in *Chicago South Shore* is questionable. As a result of the defendant's failure to comply with section 16(a), the plaintiff in *Grow Chemical* misevaluated only the prospects for acquisition, *not the issuer's business potential*. Thus, *Grow Chemical* stood only to lose the premium it paid for stock in *Guardsman* as a result of its misassessment of takeover obstacles, rather than a loss from declining market value of *Guardsman* stock had business prospects been misevaluated. *Chicago South Shore*, however, applies the protection of section 16(a) to investor loss caused by misevaluated business prospects. The broad language of *Chicago South Shore* suggests a liberal approach to section 16(a), but the differences between that situation and *Grow Chemical* make application of the language to the latter situation difficult.

Although the case law does not clearly interpret section 16(a) and *Grow Chemical* provides no analysis of the problem, there is one approach to the cases which arguably resolves the inconsistencies and supports the implication of a private right of action for investors under section 16(a). In *Remar v. Clayton Securities*<sup>59</sup> an implied private right of action was recognized under section 7 of the 1934 Act.<sup>60</sup> The *Remar* opinion conceded that the main purpose of section 7 was *not* to protect the plaintiff investor. But nevertheless, the court held that his protection was intended by Congress as a "by-product" of the main purpose and, therefore, an implied private right was justified to effectuate that secondary purpose.

The *Remar* court had little difficulty concluding that protection of the plaintiff investor was a secondary purpose, or a "by-product," of the main purpose of section 7, since the congressional history of the section expressly indicated that such a secondary purpose did exist.<sup>61</sup> While there is no comparable express language of a second-

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<sup>59</sup> 81 F. Supp. 1014 (D. Mass. 1949).

<sup>60</sup> 15 U.S.C. § 78g (1970). See note 16 *supra*.

<sup>61</sup> See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3 (1934).

ary purpose in the legislative history of section 16(a), language indicating that the section was intended to provide reliable information for investors does exist.<sup>62</sup> If that language of intention were viewed as implicit in, or a by-product of, the more obvious congressional purpose of controlling insider abuse, there would be little difficulty implying a private right of action under the available rationales. Utilizing the statutory tort approach, a plaintiff who relied on section 16(a) reports could satisfy the mechanical requirements of section 286 of the *Restatement (Second)*. Likewise, if language of secondary purpose were recognized, the congressional purpose rationale would operate effectively.<sup>63</sup> Given the *Remar* approach, those cases in which no private right was recognized under section 16(a) could be characterized as decisions ignoring the secondary purpose of the section.

The analysis by the *Remar* court, implying a private right of action to effectuate a secondary protective purpose, is buttressed by judicial interpretation of section 17(a) of the Securities Act of 1933.<sup>64</sup> In *Fischman v. Raytheon Mfg. Co.*<sup>65</sup> plaintiffs alleged certain misstatements and omissions in a registration statement covering an issue of preferred stock, which is a violation of section 11 of the 1933 Act.<sup>66</sup> Section 11 provides an express remedy for such a violation but, at the same time, imposes restrictions upon that remedy.<sup>67</sup> The district court in *Fischman* dismissed the plaintiffs' claim for failure to meet a requirement of the section. On appeal Judge Frank analyzed section 11 in relation to section 10(b) of the 1934 Act and noted, in dictum, that section 17(a) of the 1933 Act would support a private right of action for the enforcement of section 11, but free of the restrictions of section 11. Judge Frank apparently reasoned that since Congress "reasonably and without inconsistency" provided

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<sup>62</sup> *Id.* at 15.

<sup>63</sup> See notes 29-34 *supra* and accompanying text.

<sup>64</sup> 15 U.S.C. § 77q (1970). See note 18 *supra*.

<sup>65</sup> 188 F.2d 783 (2d Cir. 1951).

<sup>66</sup> 15 U.S.C. § 77k (1970). Section 11 expressly creates a cause of action for any misleading or untrue statement or omission of necessary information in a security registration statement for any person acquiring such a security. If, however, the issue of the security has made available to its security holders an earnings statement covering the period at least 12 months after the effective date of the registration statement, the right of recovery under section 11 is expressly conditioned upon proof that the plaintiff acquired a security in reliance upon the registration statement. Moreover section 11(e) provides that plaintiffs under section 11 may be required to post security for expenses of the case. Further restrictions under the section include a one year statute of limitations and an express limitation on damages recoverable.

<sup>67</sup> See note 66 *supra*.

for suits under section 10(b) of the 1934 Act — which would not be permitted under section 11 absent compliance with the requirements of section 11 — section 17(a) of the 1933 Act could also be invoked to protect defrauded persons (the goal of both sections 11 and 17) who would not qualify under section 11.<sup>68</sup>

Sections 11 and 12 of the 1933 Act provide express remedies for fraudulent misrepresentations of facts in registration statements. Just as the absence of an express remedy for violation of section 16(a) of the 1934 Act and the presence of an express remedy in section 16(b) arguably preclude a private right of action under section 16(a), the express restrictions found in section 11 of the 1933 Act arguably preclude the circumvention of those restrictions by resorting to an implied private right under section 17(a). Nevertheless, Judge Frank did not hesitate to recognize such a private right and his dictum in *Fischman* has not been repudiated.<sup>69</sup>

In *Fischman* the Court of Appeals expressed a willingness to go beyond the express provisions of the 1933 Act in order to extend protection to a plaintiff who might otherwise have no remedy. The implication of a private right of action under section 17(a)—to remedy conduct proscribed by section 11—had the effect of skirting express restrictions in section 11, yet the court apparently viewed that private right as implicit in the statutory scheme.<sup>70</sup>

The *Fischman* approach of resorting to an implied private right when an express right is unduly restrictive is ostensibly applicable in the *Grow Chemical* situation. But the statutory scheme in *Fischman* merits consideration. Sections 11, 12(2) and 17(a) of the 1933 Act constitute anti-fraud provisions, 17(a) speaking of the same general conduct as that condemned by sections 11 and 12(2). Thus, it is not difficult to create a remedy under section 17(a) for the fraudulent conduct that all three sections set about to proscribe. Consequently, the *Fischman* analysis is not necessarily applicable to the implication of a private right of action under section 16(a) of the 1934 Act where the statutory scheme of 16(a) and 16(b) works

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<sup>68</sup> *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-88 (2d Cir. 1951).

<sup>69</sup> See L. LOSS, *SECURITIES REGULATION* 3913-14 (Supp. VI 1969) and cases cited therein.

<sup>70</sup> The Second Circuit's dictum in *Fischman* did, however, state that a plaintiff who seeks to avoid the restrictions of section 11 by resorting to section 17(a) must include allegations of fraud in his complaint since a suit under 17(a) must rest upon some form of fraudulent conduct. 188 F.2d at 787 n.2. For a discussion of this requirement as well as the general impact upon securities law of an implied private right of action under section 17(a) of the 1933 Act, see 3 L. LOSS, *SECURITIES REGULATION* 1785-87 (1961).



to control abusive insider practices, but a private right is sought to remedy conduct *not* involving insider practices.

Moreover, the remedy sought in *Fischman* was of the same nature as contemplated in sections 11 and 12. The remedy sought in *Grow Chemical* was totally unrelated to that provided in section 16(b). The significance of the remedy desired in an implied private right case was recently underscored in *Globus v. Law Research Service, Inc.*,<sup>71</sup> where the court of appeals refused to allow punitive damages in a suit under section 17(a) of the 1933 Act. The court emphasized that the statutory scheme of sections 11, 12 and 17 provided compensatory relief alone and that to attach punitive damages to such a recovery would be improper.

In view of the significant differences between *Fischman* and *Grow Chemical*, one must conclude that the *Fischman* analysis will not fully support the implication of a private right of action under section 16(a) of the 1934 Act. In *Grow Chemical* the plaintiff did not seek to benefit from an express statutory scheme, as was the case in *Fischman*. Thus, the *Remar* secondary purpose approach remains the only possible link between a private right under section 16(a) of the 1934 Act and the available rationales for implying private rights to investors.

Yet without the *Fischman* analysis, *Remar* would lose much of its force when applied to the *Grow Chemical* situation. Whereas in *Remar* the secondary purpose was plainly expressed, the legislative history of section 16(a) lacks such a definitive statement. There is but a single reference to any secondary purpose in the House Report and the reference is never repeated in subsequent reports. This fact is emphasized by the sharp division of case authority interpreting the section. Thus, *Fischman* provides the only possible link between the available rationales for implied private rights of action and section 16(a).

Even if it were concluded that providing reliable information to investors is a clearly intended secondary purpose of section 16(a), a private right of action in the *Grow Chemical* situation would not automatically follow unless investor status could be attached to an *acquiring corporation*. That problem remains unresolved. Despite the fact that *Grow Chemical Corporation* characterized itself as an "investor"<sup>72</sup> in the shares of *Guardsman Chemical*, the opinion in

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<sup>71</sup> 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

<sup>72</sup> The complaint in *Grow Chemical* alleged that stock in *Guardsman Chemical* was acquired "as an investment and as a basis for exploring . . . the possibility of . . . combin-

the case clearly suggests that the prime motive was acquisition.<sup>73</sup> Application of the *Remar-Fischman* analysis would extend coverage of a provision to classes not expressly or impliedly contemplated by the provision. Thus, investor status could be extended to an acquiring corporation which relied to its own detriment upon section 16(a) reports. Given the previous discussion, however, it is apparent that the *Remar-Fischman* analysis is not available in the *Grow Chemical* situation.

An additional factor militating against application of the simple *Remar* approach to the *Grow Chemical* situation is its virtual boundless scope for future application. Under the *Remar* theory, it is difficult to conceive of anyone dealing in the securities of a corporation who would not be protected by the 16(a) requirement. No rational means of delimiting the class of persons who should be allowed to recover is apparent.<sup>74</sup>

#### IV. CONCLUSION

The development of private rights of action under federal securities legislation is necessary to further the protective function of the legislation where no effective mechanisms are provided by Congress. Private rights of action for the enforcement of sections 10(b) and 14(a) of the 1934 Act were necessary to give real significance to those provisions. The necessity for a private right under section 16(a) is not as apparent.

The available rationales for implication of private rights of action turn upon protection of an identifiable class of persons. The implication process has emphasized that private rights of action effectuate protective purposes, and where no such purpose is found, no right will be implied. No real indication exists as to who is protected by section 16(a). Both legislative history and judicial interpretation are uncertain on this point.

In *Grow Chemical* no foundation was laid by the court for the conclusion that the plaintiff was protected by section 16(a). Some recent case law has warned of the possibility of overextending implied liability and has suggested a slowdown in the implication process where it is difficult to determine who is to be protected by a

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ing the business of *Grow and Guardsman*." *Grow Chemical v. Uran*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,688 at 99,021 (S.D.N.Y. 1970).

<sup>73</sup> *Id.*

<sup>74</sup> For an analysis of the problems created by implied civil liability under section 16 see Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under 10b-5*, 65 COLUM. L. REV. 1361 (1965).

certain provision.<sup>75</sup> Rather than indulge in haphazard extensions of regulatory provisions, these courts would have Congress make the desired changes. The failure to offer a rational basis for the extension of implied liability under section 16(a), coupled with the conclusion that a *Remar-Fischman* approach is unavailable as a basis, suggests that the *Grow Chemical* court has unwarrantedly extended civil liability under section 16(a).

A private right of action under section 16(a) does not fit smoothly into the judicially developed protective scheme of the 1934 Act. To do so would require a demonstration that there exists a direct relationship between the private right and the purposes of both section 16(a) and the Act in general. As pointed out, a basis for such a fundamental relationship, while arguably present in the form of a secondary purpose, is not well defined. The broad intention of Congress to protect investors and insure continued market stability is for that reason not adequately served by an unfounded extension of liability under section 16(a).

ROBERT N. RAPP

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<sup>75</sup> See *Iroquois Industries Inc. v. Syracuse China Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,526 at 98,433 (S.D.N.Y. 1969). In *Iroquois* an attempt was made to extend the protection of Rule 10b-5, which explicitly protected defrauded purchasers and sellers, to a transaction in which *no* purchase or sale had taken place. In rejecting the attempt, the court remarked that simply because the conduct averred in any given complaint may be reprehensible does not mean that a federal remedy must be provided by judges. *Id.* at 98,437. *But see* *Crane Co. v. Westinghouse Airbrake Co.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,532 at 98,450 (2d Cir. 1969), where Rule 10b-5 was extended into an area already expressly covered by the proxy regulations of section 14(a).