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### Customers of Brokerage Firms Granted Right of Action Against Accountants Preparing Misleading Financial Statements Under Section 17(a) of the Securities Exchange Act of 1934 (Redington v. Touche Ross & Co.)

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CUSTOMERS OF BROKERAGE FIRMS GRANTED RIGHT OF ACTION AGAINST ACCOUNTANTS PREPARING MISLEADING FINANCIAL STATEMENTS UNDER SECTION 17(a) OF THE SECURITIES EXCHANGE ACT OF 1934

*Redington v. Touche Ross & Co.*

The certified public accountant has played an increasingly important role in the field of securities regulation since the enactment of the Securities Exchange Act of 1934.<sup>1</sup> The regulations promulgated under section 17(a),<sup>2</sup> which require brokers to file reports of their financial status, mandate accountant certification of various reports.<sup>3</sup> These reports often provide the basis for investment decisions. It has become the task of the federal courts to determine if and under what circumstances the "reporting provisions"<sup>4</sup> of the

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<sup>1</sup> 15 U.S.C. §§ 78a-78kk (1976).

<sup>2</sup> *Id.* § 78q(a). Prior to its amendment in 1975, section 17(a) provided, in pertinent part: Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member . . . shall make, keep, and preserve for such periods, such . . . records, and make such reports, as the [Securities and Exchange] Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such . . . records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, ch. 404, § 17(a), 48 Stat. 897 (1934) (current version at 15 U.S.C. § 78q(a) (1976)). The Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (amending § 17, 15 U.S.C. § 78q (1976)) enlarged the classes of persons who must file reports and added a disclosure provision requiring brokers to send their customers an annual certified balance sheet along with other mandatory financial statements. *See* § 17(a)(1), (e)(1)(B), 15 U.S.C. § 78q(a)(1), (e)(1)(B) (1976).

<sup>3</sup> *E.g.*, 17 C.F.R. § 240.17a-5(f) - (j), (m) (1978). Rule 17a-5 delineates the required content and objectives of the accountant's review. *Id.* § 240.17a-5(e) (content of reports); *id.* § 240.17a-5(f)(1) (qualification of accountants); *id.* § 240.17a-5(g) (audit objectives); *id.* § 240.17a-5(i) (provisions of accountants' reports); *id.* § 240.17a-5(j) (report on material inadequacies). In 1973, rule 17a-5 was amended to require accountants to report any inadequacies in the broker-dealer's accounting system and internal auditing control as well as the procedures for safeguarding securities. *See* Exchange Act Release No. 10,398 (Sept. 20, 1973) [1973] FED. SEC. L. REP. (CCH) ¶ 79,516, at 83,416-17. *See generally* Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261 (1974); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. U.L. REV. 1 (1973).

<sup>4</sup> Securities and Exchange Act of 1934 (1934 Act), § 13(a), 15 U.S.C. § 78m(a) (1976) (issuers must file with SEC information necessary to keep information in issuer's registration statement current); 1934 Act § 13(d), 15 U.S.C. § 78m(d) (person acquiring beneficial ownership of more than 5% of certain classes of securities must file statements with issuer, each exchange where security is traded and SEC); 1934 Act § 13(f), 15 U.S.C. § 78m(f) (institutional investment managers using interstate commerce and exercising investment discretion with respect to specified classes of securities of a specified aggregate fair market value must file reports with SEC); 1934 Act § 15(d), 15 U.S.C. § 78o(d) (registered issuers must file

securities laws give rise to private causes of action against those who prepare mandatory reports.<sup>5</sup> Considering section 17(a) in *Redington v. Touche Ross & Co.*,<sup>6</sup> the Second Circuit recently held that customers<sup>7</sup> of an insolvent brokerage firm may maintain an action for damages against an accountant responsible for the preparation of a misleading statement.<sup>8</sup>

In 1969, Weis Securities, Inc. (Weis), a broker-dealer registered with the Securities and Exchange Commission<sup>9</sup> and a member of the New York Stock Exchange, Inc.<sup>10</sup> engaged Touche Ross & Company (Touche Ross) to serve as its certified public accountant.<sup>11</sup> Touche Ross was responsible for the preparation, audit, and certification of the financial reports required of Weis under section 17(a) of the Act and Rule 17a-5.<sup>12</sup> In 1972 five of Weis' officers allegedly prepared false financial statements in an effort to conceal the firm's grave financial condition from the SEC and the public.<sup>13</sup> Relying on these statements, Touche Ross prepared and certified financial reports without expressing any reservations concerning Weis' financial status or mode of operation.<sup>14</sup> After Weis' true financial condition was

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reports of supplemental information concerning registered securities).

<sup>5</sup> See, e.g., *In re Penn Cent. Sec. Litigation*, 494 F.2d 528 (3d Cir. 1974) (construing 1934 Act § 13(a), 15 U.S.C. § 78m(a) (1976)); *Dewitt v. American Stock Transfer Co.*, [1977-1978] Fed. Sec. L. Rep. (CCH) ¶ 96,089 (S.D.N.Y. 1977) (construing 1934 Act, § 15(d), 15 U.S.C. § 78o(d) (1976)); *Meyers v. American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213, (S.D.N.Y. 1975), *aff'd without opinion*, 538 F.2d 312 (2d Cir. 1976) (construing 1934 Act § 13(d), 15 U.S.C. § 78m(d) (1976)); cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (private right of action may exist against accountants under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976) provided scienter demonstrated).

<sup>6</sup> 592 F.2d 617 (2d Cir.), *cert. granted*, 99 S. Ct. 563 (1978).

<sup>7</sup> Rule 17a-5(c)(4), 17 C.F.R. § 240.17a-5(c)(4) (1977), defines "customer" as "any person for whom the broker or dealer holds securities for safekeeping or as collateral or for whom the broker or dealer carries a free credit balance."

<sup>8</sup> 592 F.2d at 619.

<sup>9</sup> Section 15 of the 1934 Act, 15 U.S.C. § 78o (1976), requires broker-dealers to register with the SEC.

<sup>10</sup> As a registered securities exchange, the New York Stock Exchange is responsible for insuring that its members comply with the laws and rules governing securities transactions, § 6, 15 U.S.C. § 78f (1976).

<sup>11</sup> 592 F.2d at 619.

<sup>12</sup> *Id.*; see Rule 17a-5, 17 C.F.R. § 240.17a-5 (1973) (revised 40 Fed. Reg. 59, 712-17 (1975)). Section 4 of the 1934 Act, 15 U.S.C. § 78d (1976), authorizes the SEC to promulgate such rules and regulations as it deems necessary to effectuate the provisions of the statute.

<sup>13</sup> 592 F.2d at 619. Weis' officers allegedly overstated assets and income, understated liabilities and expenses and reported fictitious assets, creating the appearance that Weis' earnings for fiscal 1972 were \$1,700,000 when in fact they had lost more than \$1,500,000. Complaint at 4, ¶ 10, 592 F.2d at 617.

<sup>14</sup> Brief for Appellant at 7, 592 F.2d at 617; see *id.* at 620.

Under Rule 17a-5, the accountant's certificate is required to include the accountant's opinion concerning the financial statement. 17 C.F.R. § 240.17a-5(i)(3) (1978). Any matter

revealed through investigations conducted by the Exchange and the SEC,<sup>15</sup> the Securities Investor Protection Corporation (SIPC)<sup>16</sup> petitioned for a decree declaring that Weis' customers were in need of protection under the Securities Investor Protection Act of 1970 (SIPA).<sup>17</sup> A federal district judge ordered Weis' liquidation and appointed the plaintiff, Edward S. Redington, trustee for the liquidation.<sup>18</sup> SIPC and Redington subsequently commenced an action for damages against Touche Ross under section 17(a),<sup>19</sup> contending that the accounting firm's certification of the false financial statements masked Weis' precarious condition at a time when liquidation could have been prevented or the losses minimized.<sup>20</sup> The

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to which the accountant takes exception should be indicated and the effect of the exception on the corresponding item in the report should be noted. *Id.* § 240.17a-5(i)(4).

<sup>15</sup> Complaint at 5, ¶ 13, 592 F.2d at 617. After discovering that Weis had been violating the financial responsibility rules of the SEC, the Commission sought and obtained an injunction against the firm and its officers to prevent further violation of the Act. *Id.* at 620; see 15 U.S.C. § 78u(d) (1976).

<sup>16</sup> Congress enacted the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. §§ 78aaa-78111 (1976), in an effort to "restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers." SIPC v. Barbour, 421 U.S. 412, 415 (1975). The SIPA created SIPC, SIPA § 3, 15 U.S.C. § 78ccc (1976), a nonprofit corporation whose membership includes all registered brokers and dealers and all members of national securities exchanges. Its primary purpose is to "afford financial protection" to all members' customers. S. REP. NO. 1218, 91st Cong., 2d Sess. 1 (1970). This purpose is accomplished by means of a fund which is maintained by assessments on members and used to reimburse customers of insolvent members up to a maximum of \$50,000 per customer. 15 U.S.C. § 78ddd (1976).

<sup>17</sup> SIPA § 5, 15 U.S.C. § 78eee(a)(2) (1976), provides:

If SIPC determines that any member has failed or is in danger of failing to meet its obligations to customers and that there exists one or more of the conditions specified in subsection (b)(1)(A) of this section, SIPC, upon notice to such member, may apply to any court of competent jurisdiction . . . for a decree adjudicating that customers of such member are in need of the protection provided by this chapter.

The "conditions" warranting SIPC action include: (1) insolvency under the Bankruptcy Act, 11 U.S.C. § 1(19) (1976); (2) bankruptcy under 11 U.S.C. § 21 (1976); (3) the appointment of a receiver, trustee or liquidator; (4) violation of the rules, regulations or provisions of the 1934 Act concerning financial responsibility and hypothecation of customers securities; and (5) inability to make the computations necessary for compliance with the rules of financial responsibility and hypothecation. *Id.*

<sup>18</sup> Once an adjudication is made pursuant to an application by SIPC, see note 17 *supra*, the court must appoint a trustee for the liquidation of the member's business and an attorney designated by the SIPC to act as the trustee's counsel. SIPA § 5, 15 U.S.C. § 78eee(b)(3) (1976).

<sup>19</sup> 592 F.2d at 620 n.5. The trustee was able to return to Weis' customers only 67% of their investment money. Since SIPC insures accounts for only \$20,000 in cash and \$50,000 in cash and securities, see note 8 *supra*, some of Weis' customers were not fully compensated.

<sup>20</sup> One year before commencing suit in federal court, SIPC and the trustee in liquidation instituted a common law negligence action against Touche Ross in a New York state court. Redington v. Touche Ross & Co., No. 13996/76 (Sup. Ct. N.Y. County, filed July 3, 1975). In the federal suit, the common law claims were joined with a claim for relief under § 17(a).

district court dismissed the suit for failure to state a claim upon which relief could be granted.<sup>21</sup> On appeal, a divided Second Circuit panel<sup>22</sup> reversed and remanded.<sup>23</sup>

Writing for the *Redington* majority, Judge Lumbard first examined section 17(a) in light of the four factors which the Supreme Court, in *Cort v. Ash*,<sup>24</sup> deemed "relevant" to the question whether a private remedy may be inferred from a statute not expressly providing one.<sup>25</sup> He noted that the reports required by section 17(a) and the periodic examinations to which they may be subject are "for the protection of investors" and concluded customers of broker-dealers are within "the class for whose *especial* benefit the statute was enacted."<sup>26</sup>

Looking to the second of the *Ash* factors, the *Redington* court found no "indication of legislative intent, explicit or implicit, either to create [a private] remedy or to deny one."<sup>27</sup> Accordingly, it

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592 F.2d at 620.

<sup>21</sup> *Id.*

<sup>22</sup> Judge Lumbard authored the majority opinion. A separate concurring opinion was written by Judge Timbers and Judge Mulligan dissented.

<sup>23</sup> On remand the district court was to determine whether the federal suit should be stayed in favor of the state action, whether pendent jurisdiction over the common law claims should be exercised and what standards should be used to establish an accountant's liability under § 17(a). 592 F.2d at 625.

<sup>24</sup> 422 U.S. 66 (1975).

<sup>25</sup> 592 F.2d at 621 (citing *Cort v. Ash*, 422 U.S. 66 (1975)). The *Ash* criteria recently were reaffirmed in *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977). Similarly, in *Regents of the Univ. of Cal. v. Bakke*, 98 S. Ct. 2733 (1978) (White, J., concurring), Justice White relied *Ash* to determine whether a private right of action exists under Title VI of the Civil Rights Act of 1964, 42 U.S.C. § 2000d to -4 (1976).

<sup>26</sup> 592 F.2d at 621. (citing *Cort v. Ash*, 422 U.S. at 78) (emphasis added); see 15 U.S.C. § 78q(a) (1976). In addition to the express language of § 17(a), the *Redington* court noted that "an arsenal of [required] reports" exists to protect brokers' customers. 592 F.2d at 622. Financial reports must be audited and certified by independent certified public accountants. See 17 C.F.R. § 240.17a-5(d) (1978). The accountants' certificate is required to state whether the accountant reviewed the procedures followed "for safeguarding securities." *Id.* 240.17a-5(i)(2)(ii). One of these procedures is the "net capital rule," *id.* § 240.15c3-1, which requires a broker to maintain a specified minimum ratio of liquid assets to aggregate indebtedness in order to satisfy 72,129 (1967). The *Redington* court reasoned that failure to supply accurate reports deprives brokers' customers of the protection to which they are entitled since the mandated reports constitute the sole avenue through which the SEC can obtain the information necessary for enforcement of the net capital rule. 592 F.2d at 622.

<sup>27</sup> 422 U.S. at 78; see 592 F.2d at 621-22. The court distinguished § 17(a) from other statutes which have been held not to give rise to private causes of action on the ground that the latter evinced a clear legislative intent to confine the enforcement prerogative to specific governmental agencies. *Id.* at 622. (citing *Cort v. Ash*, 422 U.S. 66 (1975); (Federal Election Commission); *SIPC v. Barbour*, 421 U.S. 412 (1975) (SEC); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974) (Attorney General)). The Second

sought to discern whether under the third factor it would be "consistent with the underlying purposes of the legislative scheme to imply" a private cause of action under section 17(a).<sup>28</sup> Noting that criminal prosecutions<sup>29</sup> and SEC injunctive suits would not restore to Weis' customers the money that they had lost, Judge Lumbard concluded that the statutory remedies were not sufficient to effectuate fully the legislative purpose of broker-dealer customer protection.<sup>30</sup> Moreover, since the SEC does not have the ability to be the sole guardian of the securities industry,<sup>31</sup> the *Redington* majority reasoned that a "private remedy is an essential supplement to the scheme of enforcement of section 17."<sup>32</sup>

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Circuit, however, recently has indicated that the power to enforce the various securities acts should not necessarily be restricted to the SEC. *Abrahamson v. Fleschner*, 568 F.2d 862, 874 n.19 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

<sup>28</sup> 422 U.S. at 78; *see* 592 F.2d at 621. In *Abrahamson v. Fleschner*, 568 F.2d 862, 874 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978), the Second Circuit noted that even in the absence of "specific statements of legislative intent," an examination of underlying legislative purposes might support the creation of a private right of recovery. Such an examination is justified, in the *Abrahamson* court's view, since an explicit direction from Congress would obviate the need for further judicial inquiry. 568 F.2d at 874-75; *accord*, *SIPC v. Barbour*, 421 U.S. 412 (1975); *National R.R. Corp. v. National Ass'n of Passengers*, 414 U.S. 453 (1974).

<sup>29</sup> 592 F.2d at 623. Although at least one court has held that making false entries in the records required by § 17 constitutes a criminal offense, *United States v. Sloan*, 389 F. Supp. 526, 528 (S.D.N.Y. 1975), the existence of potential criminal sanctions does not necessarily preclude civil liability, *see Cort v. Ash*, 422 U.S. 66, 79 (1975).

<sup>30</sup> 592 F.2d at 623; *see* note 26 and accompanying text *supra*.

<sup>31</sup> 592 F.2d at 623. In 1976, there were over 5,000 broker-dealers registered with the SEC. Since close regulation of such a large number of firms is extremely difficult, the SEC and the investing public must depend largely upon the certified reports filed by broker-dealers. The threat of damages actions, the SEC has stated, would help to "assure proper professional conduct" on the part of both broker-dealers and accountants. Brief of the SEC, *amicus curiae*, at 25 n.37, 592 F.2d at 617; *see J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). In *Borak*, a stockholder sought to recover damages and have a merger declared void on the ground that it was the product of a fraudulent proxy solicitation which involved § 14(a) of the Act, 15 U.S.C. § 78n(a) (1976). Observing that it is impossible for the SEC to examine all of the proxy statements issued each year, the Supreme Court upheld the plaintiff's private cause of action as "a necessary supplement to Commission action." 377 U.S. at 432.

<sup>32</sup> 592 F.2d at 623. In reaching its conclusion, the Second Circuit in *Redington* noted that the concept of "statutory tort," breach of a statutorily created duty, lends further support to the propriety of implying a private cause of action under § 17(a). This theory has been applied to justify the creation of a private cause of action in other areas of securities law. *Id.*; *see, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (§ 78j(b)); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (§ 78n(a)); *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) (§ 78f(b)); *Spoon v. Walston & Co.*, 345 F. Supp. 518 (E.D. Mich. 1972), *aff'd per curiam*, 478 F.2d 246 (6th Cir. 1973) (§ 78g); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967) (§ 78o(b)(5)(E)); *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) (§ 78g). *See generally* RESTATEMENT (SECOND) OF TORTS § 286 (1965).

Turning to the fourth *Ash* factor, whether “the cause of action [is] one traditionally relegated to state law . . . so that it would be inappropriate to infer a cause of action based solely on federal law,”<sup>33</sup> the court decided that creation of a federal right was justified in light of the national character of the problem of broker regulation and the exclusivity of federal jurisdiction over actions arising under the securities laws.<sup>34</sup> Finally, the court rejected the district court’s finding that section 18(a) of the Act, which imposes liability for misleading statements,<sup>35</sup> provides the exclusive remedy for section 17(a) violations.<sup>36</sup> Noting that brokers’ customers are the “favored wards of section 17,”<sup>37</sup> the *Redington* majority reasoned that Congress could not have intended to limit the means of redress to Section 18(a), which permits recovery only by those who have actually purchased or sold securities.<sup>38</sup>

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<sup>33</sup> *Cort v. Ash*, 422 U.S. 66, 78 (1975); see 592 F.2d at 621; *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Wheeldin v. Wheeler*, 373 U.S. 647 (1963).

<sup>34</sup> 592 F.2d at 623.

<sup>35</sup> 15 U.S.C. § 78r(a) (1976). Section 18(a), establishing “liability for misleading statements,” provides:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

<sup>36</sup> 592 F.2d at 623.

<sup>37</sup> *Id.*

<sup>38</sup> The “purchase or sale” doctrine was upheld by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975). The *Blue Chip Stamps* Court noted that the “express . . . private civil remedies, created by Congress . . . for violations of various provisions of the 1933 and 1934 Acts are by their terms expressly limited to purchasers or sellers of securities.” *Id.* at 735-36; cf. *Rich v. Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976) (sale of securities during liquidation satisfies *Blue Chip* rule where fraud designed to induce sale). In addition to the “purchase or sale” doctrine, there are two prerequisites for § 18(a) actions. First, there must be actual, not constructive, reliance on the document. *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). Second, the price at which the security was purchased or sold must have been affected by the false or misleading report. *Rich v. Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976). Since misrepresentation in a § 17(a) report would never affect the price of a security, plaintiffs such as those in *Redington*, whose loss was the result of a broker’s financial collapse, are precluded from recovering under § 18(a). 592 F.2d at 623.

In addition to its determination that a private action could be predicated upon § 17(a), the *Redington* court held that the action could be maintained for the benefit of Weis’ customers by the Securities Investor Protection Corporation (SIPC) as subrogee and by the trustee in liquidation in his capacity as bailee for the customers. The court reasoned that SIPC’s role as an insurer entitled it to the benefit of the common law rule of subrogation, which permits recoupment of payments made. *Id.* at 624 (citing *SEC v. Albert & Maguire Sec. Co.*, [1977-

In his dissenting opinion, Judge Mulligan contended that section 17(a) does not give rise to a cause of action in favor of the customers of broker-dealers.<sup>39</sup> Observing that the *Ash* factors are to be applied only when the statute in question does not expressly provide a remedy, he concluded that they were improperly used in *Redington* since, in his view, section 18(a) demonstrates a congressional intention to exclude all other remedies.<sup>40</sup> In addition, Judge

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1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,129, at 92,076 (3d Cir. 1977)). Acknowledging that the SIPA delineates SIPC's subrogation rights, SIPA § 6, 15 U.S.C. § 78fff(f)(1) (1976), the court nonetheless found no legislative intent to abrogate common law subrogation rights. 592 F.2d at 624; cf. *Ackerman v. Motor Vehicle Accident Indemnification Corp.*, 18 App. Div. 2d 307, 239 N.Y.S.2d 463 (1st Dep't 1963) (delineation of subrogation rights of statutorily created motor vehicle insurer does not abrogate common law right of subrogation). *But cf.* *SIPC v. Associated Underwriters, Inc.*, 423 F. Supp. 168 (D. Utah 1975) (SIPC should not be viewed as insurer); *Rogers v. National Sur. Co.*, 116 Neb. 170, 216 N.W. 182 (1927) (statute's delineation of subrogation rights of "guaranty fund" for depositors of state banks precludes common law right of subrogation). The *Redington* court also noted that a contrary ruling would result in violators of the statute receiving a "windfall benefit" from the existence of SIPC in contravention of legislative policy. 592 F.2d 624. The court declined to rule on the separate question whether SIPC was entitled to bring suit on its own behalf but observed that SIPC could not be considered a member of the class for whose benefit the Act was enacted, since the legislation which created SIPC was not enacted until 1970. *Id.* n.13.

Finally, the *Redington* court rejected the trustee's claim that he was entitled to sue as Weis' representative. *Id.* at 624. The court reasoned that, as members of the class sought to be regulated by § 17, neither broker-dealers nor their representatives may avail themselves of any right of action that might arise under it. *Id.* at 624-25 (citing *Piper v. Christ-Craft Indus., Inc.*, 430 U.S. 1, 37 (1977) and *Lank v. New York Stock Exch.*, 548 F.2d 61, 65 (2d Cir. 1977)). The court however, held that the trustee was entitled to sue in his capacity as bailee of the customers' funds. 592 F.2d at 625. *See SEC v. Albert & Maguire Sec. Co.*, [1977-1978] FED. SEC. L. REP. (CCH) ¶ 96,129, at 92,076 (3d Cir. 1977); cf. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969) (trustee in bankruptcy of stockbroker permitted to maintain § 10(b) and rule 10b-5 actions on behalf of broker's customers).

<sup>39</sup> 592 F.2d at 627 (Mulligan, J., dissenting). In addition to finding no cause of action under § 17(a), Judge Mulligan dissented from the majority's holding concerning the right of SIPC and the trustee to bring suit. 592 F.2d at 634; see note 38 *supra*. Applying the principle of *expressio unius est exclusio alterius*, see note 40 *infra*, the dissent reasoned that SIPC's subrogation rights as outlined by SIPA § 6, 15 U.S.C. § 78fff(f) (1) (1976) were exclusive. 592 F.2d at 634-35. (Mulligan, J., dissenting) (citing *Rogers v. National Sur. Co.*, 116 Neb. 170, 216 N.W. 182 (1927)). Moreover, Judge Mulligan viewed the majority's decision as a circumvention of congressional intent. Finally, while concurring with the conclusion that the trustee could not sue on behalf of Weis, Judge Mulligan rejected the majority's reasoning in permitting him to sue as bailee of the Weis customers' property. No. 77-7183, slip op. at 2741 (Mulligan, J., dissenting).

<sup>40</sup> No. 77-7183, slip op. at 1726 (Mulligan, J., dissenting) (citing *Cort v. Ash*, 422 U.S. 66, 78 (1975)). Judge Mulligan relied on the principle of statutory construction, *expressio unius est exclusio alterius*. The validity of this rule recently was upheld in *SIPC v. Barbour*, 421 U.S. 412 (1975), and *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974). The limiting language of § 18(a) and the existence of other sections in the Act providing for private actions lent support to Judge Mulligan's finding of congressional intent to deny broker-dealers' customers a private right of action. 592 F.2d at 630 (Mulli-



Mulligan noted that the Supreme Court recently held that a private cause of action may not be implied unless it is "necessary . . . to accomplish the primary congressional goal."<sup>41</sup> Since he found that section 17(a)'s "prophylactic"<sup>42</sup> purpose was served more effectively by the threat of liquidation under the SIPA and criminal sanctions than by the threat of private damage actions, Judge Mulligan concluded that an implied private right was not a necessary component of the legislative scheme.<sup>43</sup>

In the 44 years since its enactment, no court has considered whether section 17(a) gives rise to a private cause of action for damages.<sup>44</sup> The question of implied causes of action has arisen, however, in connection with other reporting provisions of the securities laws. The courts that have considered these reporting sections uni-

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gan, J., dissenting); see 15 U.S.C. §§ 78e, 78p(b), 78t (1976). The concurrence in *Redington* noted, however, that the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975), implied a right of action under § 10(b) of the Act despite the lack of contrary evidence of legislative intent. 592 F.2d at 626 (Timbers, J., concurring).

<sup>41</sup> *Id.* at 631 (Mulligan, J., dissenting) (citing *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 25 (1977) (emphasis omitted)). Judge Mulligan also argued that the liberal policy in favor of implying private rights of action under the 1934 Act, see *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), has been curtailed by subsequent Supreme Court decisions. See *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *Cort v. Ash*, 422 U.S. 66 (1975); *SIPC v. Barbour*, 421 U.S. 412 (1975); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974). He concluded that the majority had "misapplied" the reasoning in these decisions. 592 F.2d at 628 (Mulligan, J., dissenting). See generally *Climan, Civil Liability Under the Credit-Regulation Provisions of the Securities Exchange Act of 1934*, 63 CORNELL L. REV. 206 (1978); Comment, *Private Rights of Action Under Amtrak and Ash: Some Implications for Implication*, 123 U. PA. L. REV. 1392 (1975); Note, *Implication of Private Actions from Federal Statutes: From Borak to Ash*, 1 J. CORP. L. 371 (1976).

<sup>42</sup> 592 F.2d at 633 (Mulligan, J., dissenting). Since the § 17(a) requirements provide the SEC with the information needed to enforce the net capital rule, see note 26 *supra*, Judge Mulligan reasoned that the protection Congress sought to give the customers of broker-dealers consists solely of "a system of reports and monitoring which would prevent insolvency of broker-dealers." *Id.* (Mulligan, J., dissenting) (emphasis in original).

<sup>43</sup> *Id.* at 634 (Mulligan, J., dissenting). Judge Mulligan further observed that if scienter were held to be the standard for accountant liability in § 17(a) actions as it is for § 10(b) suits, see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), a state common law action would provide a better opportunity for recovery than would the remedy created by the *Redington* majority. 592 F.2d at 633 (Mulligan, J., dissenting). The dissent also found unpersuasive the argument that a § 17(a) private action should be implied to assist the SEC in its regulatory functions stating: "[I]nstitutional limitations alone do not lead to the conclusion that any party . . . should have a cause of action for damages." *Id.* (Mulligan, J., dissenting) (quoting *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 41 (1977)).

<sup>44</sup> In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court deferred the question whether an accountant may be held liable for damages under § 17(a). 425 U.S. at 194 n.13.

formly have held that they do not give rise to private rights of action.<sup>45</sup>

In *In re Penn Central Securities Litigation*,<sup>46</sup> for example, the Third Circuit ruled that section 18(a) provides the exclusive private remedy for violations of section 13(a) of the Act, which requires issuers to keep their registration statements current.<sup>47</sup> Significantly, the *Penn Central* court expressed concern that a contrary ruling would circumvent the recently reaffirmed requirement that the plaintiff have suffered loss in his capacity as a purchaser or seller of securities.<sup>48</sup> In *Myers v. American Leisure Time Enterprises, Inc.*,<sup>49</sup> the court applied reasoning similar to that utilized in *Penn Central* and dismissed an action based on section 13(d), a reporting provision aimed at a designated class of securities holders.<sup>50</sup> Finally, section 15(d),<sup>51</sup> another of the reporting sections applicable to issuers, has been held not to give rise to a private cause of action.<sup>52</sup>

<sup>45</sup> See notes 46-52 and accompanying text *infra*.

<sup>46</sup> 494 F.2d 528 (3d Cir. 1974).

<sup>47</sup> *Id.* at 540; see 15 U.S.C. § 78m(a) (1976).

<sup>48</sup> 494 F.2d at 540; see note 38 *supra*. Other courts relying upon the Third Circuit's opinion in *Penn Central* have rejected section 13(a) suits. *In re Equity Funding Corp. of America Litigation* (EFCA), 416 F. Supp. 161 (C.D. Cal. 1976) (§ 13(a) and rules promulgated thereunder "administrative devices" not intended to create rights other than those supplied by § 18(a)); *McLaughlin v. Cambell*, 410 F. Supp. 1321 (D. Mass. 1976) (no private remedy exists for any reporting section); *duPont v. Wyly*, 376 F. Supp. 23 (D. Del. 1973).

In several early cases, courts within the Second Circuit construed § 13(a) to permit a private right of action. *E.g.*, *Kroese v. Crawford*, [1961-1964] FED. SEC. L. REP. (CCH) ¶ 81,262 (S.D.N.Y. 1963). In *Kaminsky v. Abrams*, 281 F. Supp. 501 (S.D.N.Y. 1968), § 13(a)-based causes of action were dismissed due to the plaintiff's failure to demonstrate reliance upon the misleading document. The court did not, however, reconsider the existence of private rights of action under the statute. By 1970, some courts were questioning whether such a cause of action was proper. *Smith v. Murchison*, 310 F. Supp. 1079 (S.D.N.Y. 1970); *accord Robbins v. Banner Indus., Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966). As late as 1973, however, a district court denied a motion to dismiss a § 13(a) claim without any comment on the issue. *In re Caesar's Palace Sec. Litigation*, 360 F. Supp. 366, 388 (S.D.N.Y. 1973). The trend since the Third Circuit's holding in *In re Penn Central Sec. Litigation*, 494 F.2d 528 (3d Cir. 1974), has been to dismiss all private § 13(a) claims. See *DeWitt v. American Stock Transfer Co.* [1977-1978] FED. SEC. L. REP. (CCH) ¶ 96,089 (S.D.N.Y. 1977); *Levy v. Johnson*, [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,899 (S.D.N.Y. 1977); *Meer v. United Brands Co.*, [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,648 (S.D.N.Y. 1976).

<sup>49</sup> 402 F. Supp. 213 (S.D.N.Y. 1975), *aff'd mem.*, 538 F.2d 312 (2d Cir. 1976).

<sup>50</sup> 402 F. Supp. at 215; see 15 U.S.C. § 78m(d) (1976).

<sup>51</sup> 15 U.S.C. § 78o(d) (1976).

<sup>52</sup> *DeWitt v. American Stock Transfer Co.*, [1977-1978] FED. SEC. L. REP. (CCH) ¶ 96,089 (S.D.N.Y. 1977). Unlike most of the cases in which reporting sections of the Act were held not to give rise to private remedies, see notes 47-52 and accompanying text *supra*, *DeWitt* involved a failure to file rather than the issuance of a false or misleading statement in a filed report. The court, however, did not consider this difference significant. *But cf.* *Kerber v. Kakos*, 383 F. Supp. 625 (N.D. Ill. 1974) (private right of action exists against issuer who "ignores registration requirements" although § 18(a) is exclusive remedy for filing false and misleading statements).

In each case where a claim predicated upon a reporting provision was rejected, the decisive factor was the court's determination that section 18(a) is the "catch-all" liability provision,<sup>53</sup> precluding all other remedies. In view of the legislative scheme underlying all the reporting sections in the securities laws, it is submitted that section 17(a) should be subject to the same reasoning. When it enacted the 1934 Act, Congress apparently viewed section 17(a) and the other reporting provisions as a unit<sup>54</sup> with the single purpose of insuring the availability of information which investors need to formulate intelligent investment decisions.<sup>55</sup> Public disclosure of information contained in required reports was viewed as a method of preserving "honest markets,"<sup>56</sup> while investor protection was the overriding goal.<sup>57</sup> Once it is recognized that section 18(a) provides

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<sup>53</sup> *In re Penn Cent. Sec. Litigation*, 347 F. Supp. 1327, 1340 (E.D. Pa. 1972), *modified on other grounds*, 357 F. Supp. 869 (E.D. Pa. 1973), *aff'd*, 494 F.2d 528 (3d Cir. 1974); *see, e.g.*, *Dewitt v. American Stock Trans. Co.* [1977-1978] FED. SEC. L. REV. (CCH) ¶ 96,089, at 91,928-29 (S.D.N.Y. 1977); *Levy v. Johnson*, [1976-1977] FED. SEC. L. REV. (CCH) ¶ 95,899, at 91,324 (S.D.N.Y. 1977); *Meer v. United Brands Co.*, [1976-1977] FED. SEC. L. REV. (CCH) ¶ 95,648, at 90,213 (S.D.N.Y. 1976); *In re Equity Funding Corp. of American Sec. Litigation* (EFCA), 416 F. Supp. 161, 190 (C.D. Cal. 1976) (*McLaughlin v. Campbell*, 410 F. Supp. 1321, 1325 (D. Mass. 1976); *Meyers v. American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213, 215 (S.D.N.Y. 1975).

<sup>54</sup> In its report to the House of Representatives, the Interstate and Foreign Commerce Committee divided the provisions of the Act into six categories: a) control of credits; b) control of manipulative practices; c) provision of adequate and honest reports to securities holders by registered corporations; d) control of unfair practices of corporate insiders; e) control of exchanges and over-the-counter markets; f) administration. *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2 (1934). *See generally* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973).

<sup>55</sup> H.R. REP. NO. 1383, 73d Cong., 2d Sess. 4 (1934).

<sup>56</sup> *Id.* Similar public policy considerations underlie each of the reporting provisions of the Act. The availability of information crucial to investment decisions was needed to renew investor confidence following the 1929 stock market crash. It was hoped that such renewed confidence, combined with governmental regulation, would avert future market crises and their consequences. *Id.* at 2; S. REP. NO. 792, 73d Cong., 2d Sess. (1934).

<sup>57</sup> Prior to the enactment of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976), the securities field was unregulated. Excessive speculation and inordinate margin purchasing were major contributing factors to the economic depression of the 1930's. During the summer of 1933, there was another "speculative boom" which demonstrated to Congress the need for legislative regulation of the market. S. REP. NO. 792, 73d Cong., 2d Sess. 2 (1934). In his February 9, 1934 message to Congress, President Roosevelt stated that the 1933 Act was "but one step in our broad purpose of protecting investors and depositors." He expressed hope that the 1934 legislation would expand the government's "protection of investors." *See id.* at 1. The courts repeatedly have acknowledged that the Act was designed primarily to protect the investor. *See Thill Sec. Corp. v. New York Stock Exch.*, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970). In *Boruski v. SEC*, 340 F.2d 991 (2d Cir.), *cert. denied*, 381 U.S. 917 (1965) the court stated: "[I]t is difficult to see how the [Securities and Exchange] Commission could carry on its task of protection of the public investor without information such as it sought [through § 17(a) and Rule 17a-5]." 340 F.2d at 992.

the sole relief for violations of section 17(a), it becomes apparent that the majority's reliance on the *Cort v. Ash* factors was misplaced, since those factors are relevant only when the statute in question does not expressly provide a remedy.<sup>58</sup>

Even if the *Ash* factors were relevant to an analysis of the securities laws' reporting provisions, it is submitted that their application does not support the creation of a private right of action under section 17(a). While it seems clear that brokers' customers are within that class of persons for whose benefit 17(a) was enacted, section 18(a) provides substantial evidence of a congressional intention to deny a private remedy. Hence, the second of the *Ash* criteria is not satisfied.<sup>59</sup> Moreover, although the implication of a private right would appear consistent with the legislative goal of customer protection, an analysis of the legislative scheme indicates that this goal was to be effectuated through public enforcement devices, such as the threat of liquidation,<sup>60</sup> criminal sanctions,<sup>61</sup> and SEC injunctions.<sup>62</sup> The additional protection for customers afforded by SIPC reimbursement<sup>63</sup> also supports the view that the legislative purposes underlying the reporting provisions are to be implemented by public and not private remedies. Finally, the availability of consumer relief in the form of state common law tort actions weighs against the need for a private remedy predicated on section 17(a).<sup>64</sup>

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<sup>58</sup> See 422 U.S. at 78.

<sup>59</sup> See note 27 and accompanying text *supra*.

<sup>60</sup> See note 17 *supra*.

<sup>61</sup> See note 29 *supra*.

<sup>62</sup> 15 U.S.C. § 78u(d) (1976). Shareholders, as well as the SEC, have the right to seek injunctions against those who violate § 13(d), *Grow Chem. Corp. v. Uran*, 316 F. Supp. 891 (S.D.N.Y. 1970), and § 13(a), *duPont v. Wyly*, 376 F. Supp. 23 (D. Del. 1973). Moreover, issuers of securities have been granted the right to bring injunctive suits based on § 13(d) violations. *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972). The right to bring injunctive suits, however, does not imply a companion right to bring damage actions. See *duPont v. Wyly*, 376 F. Supp. 23 (D. Del. 1973).

<sup>63</sup> See note 16 *supra*.

<sup>64</sup> State courts have long been faced with the dilemma of determining when liability should be imposed upon accountants in suits brought by parties with whom they are not in privity of contract. In the landmark decision *Ultramares Corp. v. Touche, Niven, & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931), a case involving accountants' common law liability, the New York Court of Appeals held that a party not in privity may recover only if the accountant is guilty of fraud. The court stated that "fraud" might include a "reckless misstatement" or the "insincere profession of an opinion" but that an "honest blunder" should not result in liability. *Id.* at 189, 174 N.E. at 448. In *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938), the Court of Appeals held that, even in the absence of deliberate fraud, accountants may be held liable to third parties for conduct that would support an inference of fraud, including a "refusal to see the obvious" or a "failure to investigate the doubtful." *Id.* at 107, 15 N.E.2d at 419; *accord*, *Blakely v. Lisac*, 357 F. Supp. 255, 266 (D. Or. 1972).

Several recent decisions have expanded accountant liability to permit recovery in negli-

With its decision in *Redington*, the Second Circuit has become the only court to have found a private right under a reporting provision of the Act.<sup>65</sup> In its apparent avoidance of the "purchase and sale" doctrine,<sup>67</sup> the court has exposed accountants to an unanticipated possibility of liability to individuals whose losses are not directly caused by the professional's misconduct. Such exposure, it is submitted, could result in a hesitancy among professionals to engage in the preparation of section 17(a) reports, thereby defeating Congress' desire to protect customers of brokerage firms. It is hoped that in future cases the courts will ameliorate the negative effects of the *Redington* decision by establishing a set of clear and narrowly drawn requirements for maintaining a private action for damages under section 17(a).<sup>68</sup>

*Robin J. Stalbow*

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gence in instances where the accountant knew that the injured party would rely on his work and where these parties are members of a determinate class. *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner, & Jacobs*, 455 F.2d 847 (4th Cir. 1972); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *White v. Guarente*, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977). *But see Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357, 360 (10th Cir. 1971) (fraud or misrepresentation required for actions by those not in privity). For a history of accountant liability to third parties, see Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967).

<sup>65</sup> See notes 46-55 and accompanying text *supra*.

<sup>66</sup> See note 38 *supra*.

<sup>67</sup> The reasoning that led the Supreme Court to establish a scienter requirement in Rule 10b-5 private damages actions, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), arguably could be applied in private suits brought under § 17(a). The *Hochfelder* Court based its holding, in part, upon its conclusion that plaintiffs should not be permitted to circumvent the absolute defense of good faith, which is available under § 18(a), by bringing suits for negligent misconduct under Rule 10b-5. 425 U.S. at 200. A second factor that influenced the *Hochfelder* Court was the absence of procedural safeguards in § 10(b) analogous to those provided in the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976), which expressly permits private recovery for negligent conduct. 425 U.S. at 209-10. Finally, the *Hochfelder* Court was persuaded by Congress' express rejection of negligence as a basis for imposing liability for damages under § 18(a). See 425 U.S. at 211 n.31. It is submitted that these considerations could be invoked by the courts to justify the creation of a scienter requirement in § 17(a) actions for damages. In addition, the courts could utilize devices such as a reliance requirement to insure that accountants are held liable only when their misconduct directly caused the plaintiff's loss. *Cf. Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968) (actual reliance on the document required for § 18(a) causes of action).