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IMPLICATION OF CIVIL LIABILITY UNDER THE NEW YORK STOCK EXCHANGE RULES AND LISTING AGREEMENT

I. INTRODUCTION

The Securities Exchange Act of 1934[1] (Exchange Act) imposes a federally supervised system of self-regulation upon the national stock exchanges.[2] Under this regulatory scheme, exchanges are required to promulgate and enforce their own rules, thereby retaining primary responsibility for controlling and overseeing the conduct of stock exchange brokers.[3] To ensure that the Securities and Exchange Commission (Commission) was not completely divested of its regulatory power over the exchanges, Congress enacted sections 5[4] and 6[5] of the Exchange Act, under which all national exchanges must register with the Commission. Under section 6(b), registration is not permitted, nor may it continue, "unless the rules of the exchange include provisions for the expulsion, suspension, or dis-

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1. 15 U.S.C. §§ 78a–78kk (1970).

2. Prior to the enactment of the Exchange Act, stock exchanges were run as private trade associations. 83 HARV. L. REV. 825–26 (1970). The current statutory scheme, devised in 1934, was promulgated due to congressional recognition of the fact that "[t]he great exchanges of this country upon which millions of dollars of securities [were] sold [were] affected with a public interest in the same degree as any other great utility." H.R. REP. No. 1383, 73d Cong., 2d Sess. 15 (1934) [hereinafter cited as 1934 HOUSE REPORT]. At the time of its promulgation, the congressional scheme of self-regulation was summarized as follows:

> The Commission is empowered, if the rules of the exchange in any important matter are not appropriate for the protection of investors or appropriate to insure fair dealing, to order such changes in the rules after due notice and hearings as it may deem necessary. The exchanges may alter their rules if more effective means are discovered to meet the same or new problems. Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped that the effect of the bill will be to give to the well-managed exchanges that power necessary to enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise.

Id.

3. *See* Silver v. New York Stock Exch., 373 U.S. 341, 349–61 (1963); Jennings, *Self-Regulation of the Securities Industry: The Role of the Securities and Exchange Commission,* 29 LAW & CONTEMP. PROB. 663 (1964).

4. 15 U.S.C. § 78e (1970). Section 5 provides that no broker, dealer, or exchange may use any facility of an exchange to effect security transactions unless the exchange is registered as a national securities exchange or is exempted from registration because of its limited volume. *Id.*

5. *Id.* § 78f (1970). Section 6 sets forth the procedures and requirements for registration of exchanges. *Id.* To register, an exchange must file an agreement to comply, and, so far as is within its powers, enforce compliance by its members with the Exchange Act and any rule or regulation made thereunder. *Id.* § 78f(a)(1). The exchange must also file, as a prerequisite to registration, an application containing, among other things, its constitution, rules, and an agreement to furnish the Commission with any amendments "forthwith upon their adoption." *Id.* § 78f(a)(2)–(4). The Commission must register an exchange if it appears that the exchange can comply with the statute and the Commission's rules, "and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors . . . ." *Id.* § 78f(d).

cipline of a member for conduct or proceeding inconsistent with just and equitable principles of trade . . . ."[6] A second source of federal regulatory control over stock exchanges — section 19 of the Exchange Act[7] — authorizes the Commission to suspend an exchange "for a period not exceeding twelve months" or to withdraw the registration of an exchange which it finds has violated the Exchange Act or any rules thereunder, or "has failed to enforce, so far as within its power, compliance therewith by a member or by an issuer of a security registered thereon."[8] This congressionally prescribed scheme of supervised self-regulation ensures that national exchanges will formulate at least a general rule requiring their members to adhere to "just and equitable principles of trade."[9]

In practice, however, the exchanges have promulgated many other rules as well, primarily for the purpose of maintaining an honest and efficient securities market.[10] In addition to enacting exchange rules applicable to exchange members, the exchanges require companies listing their securities for trading (issuers) to sign a listing agreement with the exchange.[11] These agreements contractually bind the issuer to adhere to certain requirements established by exchanges for the benefit of investors. The New York Stock Exchange (NYSE)[12] demands that financial state-

6. *Id.* § 78f(b).

7. *Id.* § 78s.

8. *Id.* § 78s(a)(1). Under section 19(b), the Commission is granted the power to change or supplement stock exchange rules when such rules are "necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange . . . ." *Id.* § 78s(b). In addition, under section 19(a)(3), the Commission is authorized to expel a member or officer whom it finds has violated any provision of the Exchange Act or its rules or has "effected any transaction for any other person who, he has reason to believe," is violating such provision. *Id.* § 78s(a)(3).

9. *Id.* § 78f(b). For a discussion of section 6(b), *see* text accompanying note 6 *supra.*

10. The New York Stock Exchange (NYSE) rules governing solicitation of proxies are one example of rules promulgated for this purpose. *See* NYSE Rules 450–60, *reprinted in* [1974] 2 NYSE GUIDE (CCH) 3805–15 [hereinafter cited as NYSE GUIDE]. Other rules within this category include those dealing with: 1) overcharges in commission rates (*see* NYSE CONST. art. XV, *reprinted in* NYSE GUIDE, *supra* at 1104–13); 2) failure by a member firm to maintain adequate capital positions (*see* NYSE Rule 325, *reprinted in* NYSE GUIDE, *supra* at 3525–49); and 3) a member firm's improper supervision over its discretionary accounts (*see* NYSE Rule 408, *reprinted in* NYSE GUIDE, *supra* at 3701–4 to 3701–5). *See also* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules,* 66 COLUM. L. REV. 12, 25–28 (1966).

11. Section 12(a) of the Exchange Act makes it unlawful for an exchange member or broker to effect a transaction in any nonexempt security on a national exchange "unless a registration is effective as to such security for such exchange." 15 U.S.C. § 78*l*(a) (1970). However, the exchange itself may still decide what securities it will list. *See* NEW YORK STOCK EXCHANGE COMPANY MANUAL B–3 to –4 (1972) [hereinafter cited as NYSE MANUAL]. The registration procedure is prescribed in subsections (b), (c), and (d) of section 12, 15 U.S.C. §§ 78*l*(b), (c), (d) (1970), and Regulation 12B promulgated thereunder, 17 C.F.R. §§ 240.12b–1 to –36 (1976).

12. The NYSE is the largest stock exchange in the United States. In 1962, the NYSE transacted eighty-six percent of the total dollar volume of all securities transactions effected over registered exchanges. *See* SECURITIES AND EXCHANGE COMMIS-

ments accompanying listing applications and those subsequently published or sent to shareholders meet certain specified standards.[13] It also obligates its listed companies to comply with certain disclosure requirements, some of which are more demanding than those of the Exchange Act.[14] However, the conditions of listing go far beyond disclosure. To qualify for listing today,

> [t]he company must be a going concern or be the successor to a going concern. While the amount of assets and earnings and the aggregate market values are considerations, greater emphasis is placed on such questions as the degree of national interest in the company, the character of the market for its products, its relative stability and position in the industry, and whether or not it is engaged in an expanding industry with prospects for maintaining its position.[15]

To effectuate compliance with these aforementioned guidelines, the constitution of the NYSE has for years provided that its board of directors may at any time suspend trading or strike a security from a list.[16]

There is nothing in the Exchange Act which imposes civil liability upon: 1) an exchange member for violation of an exchange rule; 2) a

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SION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 11 (1963).

13. In its listing application, the issuer must agree: 1) to publish at least annually an independently audited balance sheet together with a surplus and income statement, either separately for itself and every majority-held subsidiary or on a consolidated basis; 2) to submit such financial statements at least fifteen days before the annual meeting and not more than three months after the close of the fiscal year; and 3) to publish quarterly statements of earnings on the basis of the same degree of consolidation as in the annual report. *See* NYSE MANUAL, *supra* note 11, at A-64 to -73.

14. *Compare* Part I of the NYSE listing agreement, *reprinted in* NYSE MANUAL, *supra* note 11, at A-29 to -31, *with* SEC Form 8-K, Rule 13a-11, 17 C.F.R. § 240.13a-11 (1975). For a columnar comparison of the Commission's registration requirements and the NYSE's listing requirements, *see* [1975] 2 FED. SEC. L. REP. (CCH) ¶¶ 23,095-120. On the required content of the NYSE's listing application, *see* NYSE MANUAL, *supra* note 11, at B-33 to -78 & B-109 to -123.

15. NYSE MANUAL, *supra* note 11, at B-3.

16. Although there is nothing in the Exchange Act expressly limiting the exchanges' right to suspend trading in a security, section 19(b)(3) gives the Commission certain powers over exchange rules in respect of "the listing or *striking from listing* of any security." 15 U.S.C. § 78s(b)(3) (1970) (emphasis added). Additionally, SEC Rule 12d2-1(a) provides that "a national securities exchange may suspend from trading a security listed and registered thereon in accordance with its rules." 17 C.F.R. § 240.12d2-1(a) (1976). Suspension of trading does not, however, terminate the registration of a security or immunize the issuer from the reporting requirements under section 13 of the Exchange Act, 15 U.S.C. § 78m (1970), or the proxy rules promulgated under section 14 of the Exchange Act, *id.* § 78n (1970).

Trading in a security is suspended or a security is delisted when the NYSE, acting through its board of governors, determines that continued dealings on the NYSE are not advisable. For an enumeration of the criteria which the NYSE examines in making a decision to delist or suspend a security from dealings, *see* NYSE MANUAL, *supra* note 11, at A-291 to -294.1.

The Exchange Act also authorizes the Commission to suspend a security from trading or withdraw a security's registration, subject to certain conditions set forth in section 19(a)(2), 15 U.S.C. § 78s(a)(2) (1970). Under section 12(d), *id.* § 78l(d), and rule 12d2-2(f) promulgated thereunder, 17 C.F.R. § 240.12d2-2(f) (1976), the issuer likewise has a voice in the matter.

Villanova Law Review, Vol. 22, Iss. 1 [1976], Art. 6

listed company for violation of its listing agreement with an exchange; or 3) an exchange for failure to discipline either members or issuers for violation of either its rules or its listing agreement. Nevertheless, a right of action against an exchange has been recognized since the United States Court of Appeals for the Second Circuit decided the seminal case of *Baird v. Franklin*[17] in 1944. A question remaining after *Baird* was whether future courts would expand the *Baird* rationale to include an implied cause of action against an exchange member for failure to comply with the rules of the exchange.[18] Another unresolved issue concerned an even greater expansion of the theory of implied liability — whether a listed company's violation of its listing agreement with an exchange was an actionable offense.[19]

This Comment examines the judicial treatment of these issues in the area of implied private actions under the NYSE rules and listing agreement. After exploring the theoretical underpinnings of implied civil liability, the Comment reviews various cases relevant to this area. Attention is then focused upon a suggested method of determining which NYSE rules should be actionable. Next, the Comment examines the relationship between the disclosure requirements of the listing agreement and those embodied in section 10(b) of the Exchange Act[20] and rule 10b–5[21] promulgated there-

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17. 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944). In *Baird,* two customers brought suit against an insolvent NYSE member, alleging that the NYSE's failure to enforce its rules had caused their financial loss. Although the court recognized the validity of the claim asserted, recovery was denied because plaintiffs failed to prove causation. *Id.* at 244–46.

18. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966), was the first case to address this issue directly. In *Colonial,* plaintiff-investor alleged that he had suffered damages due to the failure of his broker-dealer to adhere to "just and equitable principles of trade" within the meaning of section 6(b) of the Exchange Act. *Id.* at 179–80. For a discussion of section 6(b), *see* text accompanying note 6 *supra.* Although the Second Circuit held that the complaint did not assert a valid federal claim, it did not foreclose the possibility that other NYSE rules might provide the basis for implying private rights of action. 358 F.2d at 182–83.

19. The Second Circuit has recently held that allegations that an issuer has violated his listing agreement with the NYSE and section A10 of the NYSE MANUAL are sufficient to confer federal jurisdiction under the Exchange Act. *See* Van Gemert v. Boeing Co., 520 F.2d 1373, 1382 (1975); notes 83–93 and accompanying text *infra.*

20. 15 U.S.C. § 78j(b) (1970).

21. 17 C.F.R. § 240.10b–5 (1976). This rule, promulgated by the Commission in 1942, Securities Exchange Act Release No. 3230 (May 21, 1942), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b–5 (1976).

Denbo: Implication of Civil Liability under the New York Stock Exchange

under. Finally, consideration is given to the impact which these judicially implied liabilities will have upon the scheme of supervised self-regulation mandated by the Exchange Act.

II. RATIONALES FOR IMPLYING PRIVATE ACTIONS UNDER THE EXCHANGE ACT

The implied cause of action — *i.e.*, the "extension of a civil remedy to one injured by another's breach of a statute or regulation not providing for such relief"[22] — is a prominent judicial doctrine. Although the courts have developed at least four rationales to justify implying private rights, the statutory tort theory, which authorizes an implied cause of action to preserve the rights of those whose interests the statute was designed to protect, appears to be the rationale most often applied.[23] In *Kardon v. National Gypsum Co.,*[24] the first case to recognize the existence of a private cause of action for damages under rule 10b–5, the court employed the statutory tort theory in holding that in view of the general purpose of the Exchange Act to regulate all kinds of securities transactions, "the mere omission of an express provision for civil liability is not sufficient to negative what the general [tort] law implies."[25]

A second basis for implying civil liability, statutory voidability,[26] treats the plaintiff-investor as either a party to an implied contract with

22. 77 HARV. L. REV. 285, 285 (1963). A number of implied liabilities have been judicially imposed under the Exchange Act, particularly under section 10(b) and rule 10b–5 promulgated thereunder (*see* notes 20 & 21 *supra*) and under section 14(a), 15 U.S.C. § 78(n)(a) (1970).

23. *See* 1 A. BROMBERG, SECURITIES LAW: FRAUD — SEC Rule 10b–5, at § 2.4 (1)(a) (1975).

24. 69 F. Supp. 512 (E.D. Pa. 1946).

25. *Id.* at 514. The court cited section 286 of the *Restatement of Torts,* which states:

§ 286. VIOLATIONS CREATING CIVIL LIABILITY.

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, *makes the actor liable* for an invasion of an interest of another if:

(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 that 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.

Id. at 513 (emphasis added). This section has since been rewritten to provide that the court *"may adopt"* the standard of behavior contained in a statute as the standard of care in civil suits. *See* RESTATEMENT (SECOND) OF TORTS § 286 (1965) (emphasis added). In noting that the language of the *Second Restatement* seems to provide a weaker basis for the implication of private rights, one commentator remarked that "the liability theory is so firmly ensconsed in 10b–5 jurisprudence that the later *Restatement* is unlikely to have any effect on it." *See* A. BROMBERG, *supra* note 23, at § 2.4(1)(a) n.57.

26. *See* A. BROMBERG, *supra* note 23, at § 2.4(1)(b).

his broker-dealer[27] or a third party beneficiary of the contract between the exchange and its members or listed companies.[28] The source of this

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27. It is well established that a customer who effects a securities transaction through a broker must bear any losses caused by the customs and rules of the market. *See* Bibb v. Allen, 149 U.S. 481, 489–90 (1893); Lynch v. Maw, 3 Utah 2d 271, 273, 282 P.2d 841, 843 (1955); 3 L. Loss, SECURITIES REGULATION 1812 n.427 (2d ed. 1961). The statutory voidability theory imputes to the broker a contractual agreement likewise to be bound by these "marketplace" rules. The constitution of the NYSE seems to buttress this aproach by providing that NYSE rules will automatically be incorporated into any contracts between NYSE members unless they expressly agree otherwise. *See* NYSE CONST. art. XII, § 2, *reprinted in* NYSE GUIDE, *supra* note 10, at 1090.

28. Third party beneficiary liability requires an intention on the part of the contracting parties, especially the promisee-exchange, to confer a benefit upon the customer. *See* RESTATEMENT (SECOND) OF CONTRACTS § 133(1)(b) (1973). *See also* 4 A. CORBIN, CONTRACTS § 776 (1951 & Supp. 1971). Because the exchange must intend to benefit the investor, this form of liability would seem to be limited to rules with substantive content designed for the public benefit. For a discussion of the various categories of exchange rules, *see* notes 94–102 and accompanying text *infra*. The damages recoverable in these third party beneficiary actions would be determined by the actual amount of harm foreseeable at the time the contract was made. *See* Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854). Additionally, plaintiff would have to prove the amount of his damages with reasonable certainty. *See* RESTATEMENT OF CONTRACTS § 331(1) (1932).

The major deficiency of this theory of implied liability is that an injured investor cannot always fit into the classification of "intended beneficiary," which is defined by Professor Corbin as follows:

> A third party who is not a promisee and who gave no consideration has an enforceable right by reason of a contract made by two others (1) if he is a creditor of the promisee or of some other person and the contract calls for a performance by the promisor in satisfaction of the obligation; or (2) if the promised performance will be of pecuniary benefit to him and the contract is so expressed as to give the promisor reason to know that such benefit is contemplated by the promisee as one of the motivating causes of his making the contract.

A. CORBIN, *supra* at § 776. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 133(2) (1973).

While a stockholder may be considered a third party beneficiary of a corporation's listing agreement with the NYSE, one court has refused to extend the status of "intended beneficiary" to a prospective purchaser of stock. *See* MacKubin v. Curtiss-Wright Corp., 190 Md. 52, 57 A.2d 318 (1948) (prospective purchaser denied standing to sue as third party beneficiary to recover damages alleged to have resulted from breach of listed company's agreement with NYSE to publish promptly its decision to pass a dividend). Professor Corbin, discussing *MacKubin,* remarked that "[i]t would have been helpful if the court had analyzed the purposes for which the exchange exacted the promise as a condition of listing." A. CORBIN, *supra* at § 779D.

In Gaynor v. Buckley, 318 F.2d 432 (9th Cir. 1963), the court held that failure of a listed company to comply with the NYSE's requirement of shareholder approval for authorization of options was not an actionable offense when state law did not likewise require such approval. *Id.* at 435. However, in the recent case of Weinberger v. NYSE, 335 F. Supp. 139 (S.D.N.Y. 1971), the court upheld an action for damages against the NYSE based upon the theory that the plaintiff-investor was a third party beneficiary to a contract (registration agreement filed pursuant to section 6(a)(1) of the Exchange Act, 15 U.S.C. § 78f(a)(3) (1970)) between the NYSE and the Commission. In analyzing whether Congress had intended that the NYSE be held liable to individual investors for failing to enforce its rules, the *Weinberger* court examined the congressional intent as interpreted by the court in Baird v. Franklin (*see* notes 36–43 and accompanying text *infra*) and concluded that Congress had intended to provide such a remedy. 335 F. Supp. at 144. The court reasoned that this interpretation made the investor "more than an incidental beneficiary of the

implied right is section 29(b) of the Exchange Act,[29] which voids every contract made in violation of the Act or any rule thereunder.

In *J.I. Case Co. v. Borak*,[30] the United States Supreme Court suggested a third rationale for implying causes of action under the Exchange Act. This theory, which can be referred to as statutory implication,[31] suggests that the need for a remedy to effectuate the purposes of the Exchange Act will suffice to justify the implication of a private action.[32]

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contract mandated by an Act of Congress," and, therefore, gave him an independent claim for relief. *Id.* at 144. For a further discussion of the third party beneficiary concept, *see* notes 92 & 93 and accompanying text *infra*.

29. 15 U.S.C. § 78cc(b) (1970). Section 29(b) is applicable only if there is privity of contract, "or perhaps when the plaintiff can work out a third-party beneficiary relationship." *Id. See* L. Loss, *supra* note 27, at 1759. The *Kardon* court, in applying this second theory of implication, stated:

> [A] statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute [section 29(b)] would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences.

69 F. Supp. at 514.

30. 377 U.S. 426 (1964). This case, brought under section 14(a) of the Exchange Act, 15 U.S.C. § 78n(e) (1970), provided the Supreme Court with its first opportunity to consider implied private rights of action for violations of any of the federal securities statutes. The plaintiff-stockholder in this derivative suit asserted that the corporation had deprived him of his preemptive rights by participating in a consummated merger authorized through the use of false and misleading proxy statements, allegedly in violation of section 14(a) of the Exchange Act, *id.* § 78n(a). 377 U.S. at 427. Plaintiff based his assertion of federal jurisdiction upon section 27 of the Exchange Act, 15 U.S.C. § 78aa (1970). 377 U.S. at 429.

Section 14(a) makes it unlawful "for any person . . . in contravention of such rules and regulations as the Commission may prescribe . . . for the protection of investors, to solicit . . . any proxy . . . ." 15 U.S.C. § 78n(a) (1970). Section 27 grants the federal district courts exclusive jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by this chapter [Exchange Act] or the rules and regulations thereunder." *Id.* § 78aa.

31. *See* A. BROMBERG, *supra* note 23, at § 2.4(1)(c).

32. The *Borak* Court, sustaining plaintiff's federal cause of action, pointed to the broad remedial purposes of section 14(a):

> The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation . . . . It was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders."

377 U.S. at 431, *quoting* 1934 HOUSE REPORT, *supra* note 2, at 14. The Court then noted that although the language of section 14(a) made no specific reference to private actions, "among its chief purposes [was] 'the protection of investors,' which certainly implie[d] the availability of judicial relief *where necessary to achieve that result.*" 377 U.S. at 432 (emphasis added), *quoting* S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934). In conclusion, the Court quoted its own decision in Deckert v. Independence Shares Corp., 311 U.S. 282 (1940):

> "The power *to enforce* [granted to the district courts by § 27] implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case."

377 U.S. at 433-34, *quoting* Deckert v. Independence Shares Corp., 311 U.S. at 288 (emphasis supplied by the Court).

Statutory policy,[33] the final basis for implying private actions, encompasses the three previously discussed theories and seeks to ensure enforcement of the statutory policy of providing "complete and effective sanctions, public and private, with respect to the duties and obligations imposed under" the Exchange Act.[34] Support for this theory can be found in section 2 of the Exchange Act.[35]

III. CASE LAW

A. *Actions Against the Exchange*

Baird v. Franklin,[36] decided by the Second Circuit in 1944, was the first instance of judicial recognition that a registered exchange could be held civilly liable for failure to enforce its own rules. The majority of the *Baird* court "accede[d] to the view" that the exchange had breached a duty when it failed to enforce its rules.[37] However, finding the requisite causation absent, it affirmed the lower court's dismissal of plaintiffs' complaints.[38] Judge Clark, dissenting on the causation holding,[39] interpreted section 6(b) of the Exchange Act as requiring the exchanges not only to enact rules designed to promote just and equitable principles of trade, but to enforce them as well.[40] After acknowledging that one purpose of the Exchange Act was investor protection, he addressed the issue of implied rights:

> Section 2 [of the Exchange Act] also states that another goal of the statute is to make the control of securities transactions "reasonably complete and effective." If these aims are to be followed by the Act, then, if the investing public is to be completely and effectively protected, § 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges.[41]

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33. *See* A. BROMBERG, *supra* note 23, at § 2.4(1)(d).

34. Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (action by defrauded purchaser of corporate stock for damages and other relief).

35. Section 2 states that "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . ." 15 U.S.C. § 78b (1970). Another goal of the statute which is enunciated in this section is to make the control of securities transactions "reasonably complete and effective." *Id.*

36. 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944). For a summary of the court's holding, *see* note 17 and accompanying text *supra*.

37. *Id.* at 239.

38. *Id.*

39. *Id.* at 240 (Clark, J., dissenting in part).

40. *Id.* at 244. Judge Clark asserted that "[a]ny other construction would render the provision meaningless." *Id.* For a discussion of section 6(b), *see* text accompanying note 6 *supra*.

41. 141 F.2d at 244–45, *quoting* 15 U.S.C. § 78b (1970). Judge Clark seemed to adopt the statutory tort theory of implication:

> The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for

The scope of the implied cause of action recognized in *Baird* is quite narrow: first, the NYSE's duty to investigate and discipline members does not arise until the NYSE has reason to believe that the member has violated its rules;[42] second, the NYSE's failure to fulfill this duty does not become an actionable offense unless this course of conduct would serve to prevent the plaintiff's loss.[43]

The rule of *Baird* was extended to negligent violations of section 6 in *Pettit v. American Stock Exchange,*[44] a case decided nineteen years after Judge Clark's articulation of the theory of implied exchange liability. The 1967 decision of *Butterman v. Walston & Co.*[45] marked a retreat from the *Pettit* court's holding that exchanges were liable for negligent failure to enforce their rules.[46] The Seventh Circuit concluded in *Butterman* that the NYSE

> had no duty to supervise or review . . . [the member's or broker's] activities, nor any liability because of violation of its rules where it had no knowledge, or reasonable way of gaining knowledge, of alleged violations, and no duty to enforce its rules against violators *until it had, or should have had, knowledge of violation* or suspected violation.[47]

B. *Actions Against Exchange Members*

The first case to consider the question of whether exchange members could be held civilly liable for violating exchange rules was the Second Circuit's 1966 decision in *Colonial Realty Corp. v. Bache & Co.*[48] While

injuries resulting from its breach and that the common law will supply a remedy if the statute gives none.

141 F.2d at 245 (citations omitted); *see* note 23 and accompanying text *supra.*

42. 141 F.2d at 239.

43. *Id.*

44. 217 F. Supp. 21 (S.D.N.Y. 1963). In *Pettit,* the trustee in bankruptcy of a company with shares listed on the American Stock Exchange brought suit against that exchange, alleging that defendant's failure to carry out its obligations under section 6 of the Exchange Act permitted the perpetration of a scheme to defraud the listed company. *Id.* at 29. For a discussion of section 6(b), *see* text accompanying note 6 *supra.*

45. 387 F.2d 822 (7th Cir.), *cert. denied,* 391 U.S. 913 (1967). In *Butterman,* stock purchasers brought suit against their stockbroker, the NYSE, and the NYSE's president, seeking to recover for money losses allegedly caused by the NYSE's failure to enforce its rules. 387 F.2d at 823. The complaint charged that the NYSE was negligent in failing to supervise its members as required by the NYSE rules and constitution, thereby enabling the defendant stockbroker to "falsely hold herself out as a duly registered seller of securities." *Id.* at 824. The court held that plaintiffs had failed to meet their burden of disclosing a genuine issue of material fact. *Id.*

46. *See* Pettit v. American Stock Exch., 217 F. Supp. at 29-30.

47. 387 F.2d at 825 (emphasis added).

48. 358 F.2d 178 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966). This controversy arose when defendant-broker sold securities from Colonial's margin account, allegedly in violation of an oral agreement between the parties that no such sale would be effected unless the margin account fell below the minimum amount required by the NYSE. *Id.* at 179. Colonial's complaint predicated jurisdiction upon an implied right of action under the Exchange Act, asserting that Bache's alleged conduct was "inconsistent with just and equitable principles of trade" within the meaning of section 6(b)

the *Colonial* court expressed approval of the holding in *Baird,* it pointed out that the *Baird* court's implication of a cause of action against an exchange for failure to enforce its rules did not necessarily mandate a similar right of action against a member who had violated them.[49] In discussing whether civil liability could be imposed for violation of stock exchange rules, the *Colonial* court observed that different rules had been adopted for different reasons and thus bore different relationships to the Exchange Act and the Commission's regulations thereunder.[50] Examining NYSE Rule 401, promulgated under section 6(b) of the Exchange Act, the *Colonial* court remarked that this rule "could hardly be broader."[51] The court also noted that section 6(b) seemed to anticipate that investors would be protected solely through the exchanges' enforcement of their own rules; therefore, it was highly unlikely that Congress had intended for rule violations to give rise additionally to civil claims brought by private investors.[52] In con-

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(*see* text accompanying note 6 *supra*) and the rules and constitution of the NYSE. *Id.* at 179–80. Specifically, plaintiff contended that Bache had violated article XIV, section 6 of the NYSE Constitution and NYSE Rule 401. Article XIV, section 6, provides:

> A member, allied member, member firm, member corporation or director of a member corporation who or which shall be adjudged guilty, in a proceeding under this Article of a violation of the Constitution of the Exchange or of a violation of a rule adopted pursuant to the Constitution or of a violation of a resolution of the Board of Directors regulating the conduct or business of members, allied members, member firms or member corporations or of conduct or proceeding inconsistent with just and equitable principles of trade may, if a member, allied member, member firm or member corporation, be suspended or expelled or, if an approved person, have his approval withdrawn.

NYSE CONST. art. XIV, § 6, *reprinted in* NYSE GUIDE, *supra* note 10, at 1095. NYSE Rule 401 states: "Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business." NYSE GUIDE, *supra* note 10, at 3695. For a further discussion of the *Colonial* court's holding, *see* note 18 *supra.*

49. 358 F.2d at 181.

50. *Id.*

51. *Id.* For the text of rule 401, *see* note 48 *supra.*

52. 358 F.2d at 181. The court felt that another factor tending to negate an implied right under section 6(b) was the absence of any reference to NYSE rules in section 27 of the Exchange Act, 15 U.S.C. § 78aa (1970) (the jurisdictional provision), since exchange rules were specifically mentioned in other sections of the Exchange Act, such as section 29(a), *id.* § 78cc(a) (1970). 358 F.2d at 181–82. One commentator was quite critical of the *Colonial* court's analysis of these two Exchange Act sections:

> The use of section 29(a) — with its inclusion in the non-waiver stipulation of exchange rules required by the Exchange Act, which clearly includes the section 6(b) rule — to aid in a negative conclusion on implied rights is proper in the sense that the wording of section 29(a) and of other sections proves the point about the reference to "rules" in section 27; but section 29(a) itself is, because of the non-waiver language, the best technical argument for creation of implied rights for violations of the section 6(b) rule.

Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements,* 17 CASE W. RES. L. REV. 925, 999 (1966). For a discussion of the statutory voidability theory under section 29, *see* notes 26–29 and accompanying text *supra.*

clusion, the court enunciated its landmark test for determining when a violation of an exchange rule should be actionable in a suit brought by an injured investor:

> [W]e cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a *substitute for regulation by the SEC* itself . . . .
>
> What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.[53]

Three years after the Second Circuit articulated the "substitution test"[54] for determining which NYSE rules should provide a basis for private suits against NYSE members, the Seventh Circuit, in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[55] enunciated an alternative to the *Colonial* rationale. The court, upholding plaintiff's cause of action, held that jurisdiction could properly be based upon section 27 of the Exchange Act.[56] It then espoused the following test for determining when a violation of a NYSE rule is actionable: "[T]he touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct protection of investors.' "[57]

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53. 358 F.2d at 182 (emphasis added). The court found that the rules in issue in *Colonial* did not satisfy this test since they were very broad and vague and it was unlikely that Congress had meant them to impose a new legal standard upon exchange members. *Id.* The court also stated that a contrary holding would have a disruptive effect upon the securities markets. *Id.* at 182–84.

54. *See* note 53 and accompanying text *supra.*

55. 410 F.2d 135 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969). In *Buttrey,* a trustee in bankruptcy alleged that defendant Merrill Lynch had violated NYSE Rule 405, the "Know Your Customer Rule," with respect to its dealings with the bankrupt. 410 F.2d at 137; *see* NYSE Rule 405, *reprinted in* NYSE GUIDE, *supra* note 10, at 3697.

56. The court cited the jurisdictional provision of the Exchange Act, section 27, 15 U.S.C. § 78aa (1970), and held that there was

> nothing inconsistent with th[at] Section in holding that violations of Rule 405 m[ight] be actionable as a "duty created by this chapter" [Exchange Act] inasmuch as Rule 405 was promulgated in accordance with Sections 6 and 19 of the Act, even if Rule 405 [was] not . . . itself . . . considered a rule "thereunder."

410 F.2d at 142. For a discussion of alternative jurisdictional bases for implied actions under federal law, *see* Wolfson & Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules,* 58 CALIF. L. REV. 1120, 1127–29 (1970); Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules,* 83 HARV. L. REV. 825, 832–34 (1970).

57. 410 F.2d at 142, *citing* Lowenfels, *supra* note 10, at 29. Lowenfels suggests that the courts adopt the following method of determining when to allow private parties to recover for damages sustained as a result of rule violations:

> Rather than the present case law's mechanical distinction between actions brought against an exchange and actions brought against private parties, a more

The court cited with approval the district court's determination that rule 405 served both an actionable public protection function and a nonactionable "housekeeping" function.[58] Due to this dual aspect of the rule, the court held that its alleged violation was not per se actionable but instead required a case-by-case scrutiny of available proof to determine whether the offense was one which would give rise to civil liability under section 6 of the Exchange Act.[59]

In *Wells v. Blythe & Co.*,[60] the next case in this line of decisions, the United States District Court for the Northern District of California held that an allegation of defendant's negligent violation of a rule of the National Association of Securities Dealers (NASD) was insufficient to state a federal cause of action.[61] The court, however, seemed to indicate that an allegation of fraudulent or manipulative conduct would provide the basis for implied civil liability predicated upon the violation of the "suitability" rule of the NASD.[62] Other cases following *Colonial* and *Buttrey* have likewise made an allegation of fraud the touchstone of civil liability.[63]

> fruitful approach might be to determine whether the reasons behind a particular exchange rule justify its use as a basis for imposing liability either upon the exchange or a private party. Simply stated, exchange rules which are promulgated for the direct protection of the investing public should give rise to private actions against an exchange and other private parties, while rules promulgated merely as "housekeeping" devices to guide the membership should not.

Lowenfels, *supra* note 10, at 24–25.

58. 410 F.2d at 141.

59. *Id.* at 142–43. In adopting the "public benefit" theory suggested by Lowenfels, the *Buttrey* court departed sharply from the *Colonial* court's holding that a rule is actionable only if it is a substitute for a federal statute. *See* note 53 and accompanying text *supra*. One possible explanation for the result in *Buttrey* is that the court expressly mentioned that the allegations there were "tantamount to fraud on the bankrupt's customers, thus giving rise to a private civil damage action." 410 F.2d at 143. Unfortunately, it is impossible to determine with exactitude the actual effect which this allegation of defendant's actual fraud had upon the *Buttrey* court's final resolution of the case.

60. 351 F. Supp. 999 (N.D. Cal. 1972). *Wells* involved an action by customers of a broker of defendant Blythe & Co. for damages resulting from the broker's failure to execute a sell order on a specific date. *Id.* at 999. The plaintiffs' alleged loss was caused by a subsequent decline in the value of the stock in question. *Id.*

61. *Id.* at 1001–02.

62. *Id.* at 1002. The NASD "suitability rule" is the equivalent of NYSE Rule 405 (*see* note 55 *supra*). *See* NASD CONST. art. III, § 2, *reprinted in* [1975] 3 FED. SEC. L. REP. (CCH) ¶ 25,592.

63. *See, e.g.*, SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) (brokerage firm held liable to its customers for damages incurred due to failure to inspect and review the correspondence of its president, who had fraudulently induced customers to transfer money to him); Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis, [1969–1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,748, at 99,272 (N.D. Ill., Apr. 7, 1970) (court applied *Buttrey* rationale and refused to allow recovery for violation of NYSE Rule 405 absent a showing of fraud); Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160 (S.D. Tex. 1969) (court stated that it would require a rule violation equivalent to fraud to allow recovery under NASD suitability rule); Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (court noted that Exchange Act was directed against fraud, not against negligence, but refrained from disposing of the case upon this basis because of its holding that

This approach, permitting only those rules which mirror the fraud provisions of the federal securities laws to be actionable, will doubtless undermine the rationales of both the "substitution" and the "public benefit" tests.

Starkman v. Seroussi, decided by the United States District Court for the Southern District of New York,[64] illustrates yet another consequence of the judicial implication of civil liability under stock exchange rules. The issue presented in *Starkman* was whether a violation of the NYSE rules conferred a private right of action under the Exchange Act so as to vest exclusive jurisdiction in the federal courts under section 27 of the Act,[65] thereby allowing the customer to prosecute his suit in federal court instead of compelling him to submit his claim to arbitration.[66] After holding that rule violations were "such an integral part of the transaction as to constitute a sufficient claim for violation of sections 6 and 19 of the Exchange Act,"[67] the court ruled that the customer was entitled to be heard in federal court and "[could] not be compelled to submit his claim to arbitration."[68]

plaintiff was estopped by her own actions from proving a violation of the NASD suitability rule).

64. 377 F. Supp. 518 (S.D.N.Y. 1974). In *Starkman,* a customer brought an action against his broker for alleged violations of the NYSE rules prohibiting representatives from participating in transactions with customers. *Id.* at 520.

65. 15 U.S.C. § 78aa (1970).

66. 377 F. Supp. at 524. This issue arose when the broker attempted to enforce an arbitration provision in an agreement signed by plaintiff at the time he opened his securities account. *Id.* at 521. When plaintiff refused to arbitrate, the broker defended in federal court by asserting that plaintiff's claim did not involve a violation of the Exchange Act and was therefore clearly within the arbitration clause which plaintiff had signed. *Id.* at 520-21.

67. *Id.* at 524.

68. *Id.* In reaching this conclusion, the court relied heavily upon the United States Supreme Court decision of Wilko v. Swan, 346 U.S. 427 (1953). In that action, brought by a customer against a brokerage firm under section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) (1970), the Court held that a customer's agreement to arbitrate future controversies was void under section 14 of that Act. 346 U.S. at 434-35. Section 14 provides that: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1970).

The *Wilko* Court ruled that a customer's agreement to arbitrate is a "stipulation" and that "the right to select the judicial forum is the kind of 'provision' that cannot be waived under § 14 of the Securities Act." 346 U.S. at 435. The corollary to this holding is that a broker would likewise be entitled to stay arbitration whenever he preferred to have the suit heard in federal court. One commentator has suggested that in many instances it would behoove a broker to take this action. For example:

> In a relatively small claim a plaintiff would be required to engage his own counsel, which he need not do in arbitration. Consequently, final judgment would be delayed for several years, probably at great expense to the plaintiff. A large broker is well equipped to handle small litigation with an in-house staff, and could delay a speedy resolution of the claim at a minimal cost to itself.

Hoblin, *A Stock Broker's Implied Liability to Its Customer for Violation of a Rule of a Registered Stock Exchange,* 39 FORDHAM L. REV. 253, 269 (1970). The same author further hypothesized that a broker would prefer arbitration when he was right and the courts when he was wrong, primarily because it is much easier to confuse a jury with the technicalities of the trade than it is to confuse an arbitrator who is quite familiar with the securities business. *Id.*

C. *Actions Against Listed Companies*

Another potential defendant in an implied private rights action is an issuer whose securities are listed on a national stock exchange.[69] The liability of the issuer must be predicated upon its listing agreement with the exchange and not upon the stock exchange rules, as is the case with the liability of exchange members.[70] Unfortunately, the courts (as well as litigants) have not always clearly distinguished between these two distinct causes of action.[71] Illustrative of this lack of differentiation is the United States District Court for the Southern District of New York's analysis of the controversy presented in *Kroese v. New York Stock Exchange*,[72] a 1964 action brought against a company whose trust certificates were listed on the NYSE. The plaintiff in *Kroese* based his action upon alleged violations of both NYSE Rule 499[73] and the "supplementary material"[74] which followed the rule in the NYSE Guide,[75] the publication containing rules and policies applicable to NYSE members. Specifically, plaintiff alleged that the company had failed to hold regular meetings of its certificate holders.[76] The court dismissed the action, finding no requirement in the rules of the NYSE that issuers hold regular meetings;[77] at no point in the opinion did the court take note of the fact that it was the supplementary material, in reality a part of the NYSE Manual[78] containing the

69. For an enumeration of the requirements imposed upon issuers when they list their securities on a national stock exchange, *see* notes 11–16 and accompanying text *supra*.

70. One commentator has suggested that the same liabilities which arise out of a breach of the listing agreement should also arise for breach of obligations imposed by the NYSE Manual. *See* Shipman, *supra* note 52, at 1009 n.420. *See also* note 78 *infra*. This appears to be a sound approach and is the one adopted by the Second Circuit in Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir. 1975). For a discussion of *Van Gemert, see* notes 83–93 and accompanying text *infra*.

71. *See, e.g.*, O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Kroese v. New York Stock Exch., 227 F. Supp. 519 (S.D.N.Y. 1964). For a discussion of the *O'Neill* and *Kroese* cases, *see* notes 72–82 and accompanying text *infra*.

72. 227 F. Supp. 519 (S.D.N.Y. 1964). The plaintiff in *Kroese* alleged that the defendant had failed to comply with a rule of the NYSE which plaintiff interpreted as requiring listed companies to hold regular meetings of owners. *Id.* at 519, 521.

73. Rule 499 states that "[s]ecurities admitted to the list may be suspended from dealings or removed from the list at any time." NYSE Rule 499, *reprinted in* NYSE GUIDE, *supra* note 10, at 4235–39. It seems clear that the rule itself imposes no duties upon the listed companies.

74. 277 F. Supp. at 520. This "supplementary material" is merely an excerpt from the NYSE Manual. *See* NYSE MANUAL, *supra* note 11, at A–291 to –294; note 78 *infra*.

75. The NYSE GUIDE is "the official publication of the Directory, Constitution, Rules and Policies of the Exchange. . . . Its central purpose is to provide *Members, Allied Members* and *Registered Representatives* of the Exchange with complete, up-to-date information concerning the various facets of their business as brokers and dealers." NYSE GUIDE, *supra* note 10, at 101 (emphasis added).

76. 227 F. Supp. at 519.

77. *Id.* at 521.

78. The introduction to the NYSE Manual provides:

This Manual is an attempt to present, in ready reference form, methods and procedures for publicizing corporate actions for the benefit of holders of securities,

NYSE's policies and requirements with respect to listed companies, which imposed these requirements upon the issuer. It is thus evident from its treatment of the case that the *Kroese* court failed to recognize that an action against an issuer must be based upon the listing agreement and the materials included in the NYSE Manual and not upon the rules of the NYSE.[79]

O'Neill v. Maytag,[80] decided by the Second Circuit in 1964, was the next case to deal with the implied liability of a listed company. In denying plaintiff's request to amend his complaint to include an allegation of a NYSE rule violation,[81] the court remarked:

> Whether or not such a violation might give rise to a cause of action against the defendants under state law, we do not think that it does so under federal law. The Exchange itself is under a federal duty to enforce its rules, and this duty may be enforceable in a private suit. It does not follow, however, that a suit against a listed company or its officers based on violation of an Exchange *rule* arises under federal law, and we see no reason for so holding.[82]

Van Gemert v. Boeing Co.,[83] decided by the Second Circuit in July 1975, was the first decision to both recognize and discuss the possibility of implied liability for violation of the NYSE Listing Agreement and portions of the NYSE Manual. The complaint in that class action, brought by nonconverting holders of the Boeing Company's convertible debentures, alleged that Boeing's failure to give them adequate and reasonable notice of its intention to redeem its securities was responsible for their failure

and the relationships of those actions to the proper conduct of a securities market place. It includes a codification of the policies, requirements, procedures and practices of the Exchange relating to *listed companies* and their securities . . . . NYSE MANUAL, *supra* note 11, at iii (emphasis added).

79. *See* note 70 and acompanying text *supra. See also* notes 75 & 78 *supra.*

80. 339 F.2d 764 (2d Cir. 1964). Plaintiff brought a shareholder's derivative action, alleging that management had induced his company to purchase a large block of stock at a premium solely to protect its own control position. *Id.* at 766-67. After the court held that the complaint did not state a cause of action under section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1970), rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1976), or section 409(b) of the Federal Aviation Act, 49 U.S.C. § 1379(b) (1970), plaintiff moved to amend his complaint to set forth a cause of action under the NYSE rules. *Id.* at 770.

81. *Id.* at 770. Like the plaintiff in *Kroese* (*see* notes 71-79 and accompanying text *supra*), the plaintiff in *O'Neill* failed to distinguish between a cause of action based upon a NYSE rule (not applicable to a listed company) and a cause of action based upon the NYSE Listing Agreement and the supplementary materials found in the NYSE Manual. The *O'Neill* court unfortunately made the same mistake. *See* text accompanying note 82 *infra.*

82. 339 F.2d at 770 (citations omitted) (emphasis added). Judge Friendly, writing for the court in *Colonial* (*see* notes 48-53 and accompanying text *supra*), remarked that the *O'Neill* court had repudiated "a belated attempt to rest federal jurisdiction on a listing agreement between a corporation and the NYSE." Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966).

83. 520 F.2d 1373 (2d Cir. 1975).

to exercise their conversion rights.[84] Plaintiffs' first contention was that Boeing was civilly liable under federal law for violating both the NYSE listing agreement[85] and section A10 of the NYSE Manual,[86] since these NYSE requirements were

> an extension of the Securities Exchange Act of 1934 and an integral part of the statutory scheme under which exchanges [were] required to adopt rules, 15 U.S.C. § 78f, which [could] be ordered by the Commission to be altered, 15 U.S.C. § 78s, and the violation of which [could] give rise to a civil action under federal law.[87]

Terming this claim a "colorable" one, the court reasoned that the listing agreement and NYSE Manual were "instruments corresponding" to NYSE rules within the coverage of section 6(a)(3) of the Exchange Act.[88]

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84. *Id.* at 1374-75. Plaintiffs alleged damages based upon the fact that their debentures were worth less per $100 of principal amount when redeemed after the call deadline than they would have been worth at the cutoff date for the exercise of their conversion privileges. *Id.* at 1374.

85. The listing agreement between Boeing and the NYSE, dated November 5, 1957, provided in pertinent part:

> The Corporation will *publish immediately to the holders* of any of its securities listed on the Exchange *any action taken* by the Corporation *with respect* to dividends or to the allotment of rights to subscribe or *to any rights or benefits pertaining to the ownership of its securities listed on the Exchange;* and will give prompt notice to the Exchange of any such action; and *will afford the holders of its securities listed on the Exchange a proper period within which* to record their interests and *to exercise their rights. . . .*

Id. at 1376 (emphasis supplied by the court); *see* NYSE MANUAL, *supra* note 11, at A-34.

86. *See* NYSE MANUAL, *supra* note 11, at A-170 to -180. This section deals with redemption of listed securities and details the publicity and notice to the NYSE which are required when a listed company takes this action. The defendant in *Van Gemert,* in response to plaintiffs' demand for admission, admitted that it had not issued a general publicity release in connection with the redemption of debentures, as required by section A10 of the NYSE Manual, until March 25, 1966 — four days before the expiration of the conversion privilege on March 29, 1966. 520 F.2d at 1377-78. Since the Boeing board of directors had authorized the call on February 28, 1966, and had firmed up key dates for redemption and expiration of the conversion rights shortly thereafter, 526 F.2d at 1377, the delay in releasing this information to the public was clearly violative of the command of Section A10, which provides: "Such news release shall be made as soon as possible after corporate action which will lead to, or which looks toward, redemption is taken . . . ." NYSE MANUAL, *supra* note 11, at A-170.

87. 520 F.2d at 1379 (citation omitted).

88. *Id.* at 1380. Section 6 of the Exchange Act delineates the requirements which an exchange must fulfill in order to be registered with the Commission. 15 U.S.C. § 78f (1970). In addition to a registration statement, an exchange must file with the Commission "[c]opies of its Constitution, articles of incorporation . . . and of its existing bylaws or rules or *instruments corresponding thereto,* whatever the name . . . ." *Id.* § 78f(a)(3) (1970) (emphasis added).

Noting that the Second Circuit refused to imply a federal cause of action against a listed company in O'Neill v. Maytag (*see* notes 80-82 and accompanying text *supra*), the *Van Gemert* court remarked that it now felt bound to alter that position in light of its more recent holding in *Colonial* (*see* notes 48-55 and accompanying text *supra*) and the developing case law in this area. 520 F.2d at 1380-81, *citing* Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974); SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied,* 409 U.S. 880 (1972). *See* notes 63-68 and accompanying text *supra.*

The court accepted plaintiffs' position that an issuer representing to the public that it was listed on the NYSE should be required to live up to the standard of trustworthiness which the investing public attaches to that status[89] and dismissed as "equivocal" the legislative history cited by Boeing in support of its position that Congress had not intended to extend the ambit of the NYSE rules and regulations to issuers.[90] In conclusion, the court rejected Boeing's additional contention that the NYSE's remedies were limited to delisting.[91]

Plaintiffs' second theory of recovery was that under state law they were third party beneficiaries of the listing agreement between Boeing and the NYSE, as supplemented by the NYSE Manual.[92] While the majority of the court never reached this contention, Judge Oakes, the author of the opinion, would have upheld his claim.[93]

IV. IMPLIED LIABILITY UNDER NYSE RULES: DETERMINATION OF WHICH NYSE RULES ARE ACTIONABLE

An analysis of the judicial treatment of implied causes of action under the NYSE rules from 1944 to the present time seems to reveal a growing willingness on the part of the courts to hold that the violation of at least some of these rules or some part of the listing agreements is actionable. The question now facing the judiciary is whether these cases should be resolved by application of the *Colonial* "substitution" test,[94]

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89. 520 F.2d at 1381. The court stated:

> The public generally understands that a company must meet certain qualifications of financial stability, prestige, and fair disclosure, in order to be accepted for that listing, which is in turn so helpful to the sale of the company's securities. Similarly it is held out to the investing public that by dealing in securities listed on the New York Stock Exchange the investor will be dealt with fairly and pursuant to law.

Id.

This reasoning is reminiscent of the "shingle theory" associated with the case of Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), *cert. denied,* 321 U.S. 786 (1944). The theory is that a dealer, by hanging out his shingle, impliedly represents that he will deal fairly with the public. *See generally* 3 L. Loss, *supra* note 27, at 1482–93.

90. 520 F.2d at 1382. Boeing had pointed to the congressional debates held on a proposed section 12(b)(1) to the Exchange Act. This proposal, although not adopted, would have made it mandatory for listed companies to agree to comply with the Exchange Act and the Commission's rules and regulations, and, according to the court, "much of the debate related to whether the provision was necessary at all since such companies would have to comply with the law regardless of any such agreement." *Id.* at 1382, *citing* 78 CONG. REC. 8585 (1934) (remarks of Sen. Hastings). The court ruled that by omitting the proposed section, Congress was merely recognizing the fact that it was unnecessary. *Id.* at 1382.

91. 520 F.2d at 1382.

92. *Id.* at 1380.

93. *Id.* at 1382 n.19. Judge Oakes would have held that an issuer's security holders were creditor beneficiaries and that the corporation was therefore obligated to treat them fairly. *Id., citing* RESTATEMENT OF CONTRACTS § 136 (1932). For a further discussion of this theory of third party beneficiary liability, *see* note 28 *supra.*

94. *See* text accompanying note 53 *supra.*

the *Buttrey* "public benefit"[95] test, or some new test to be articulated in the future. Regardless of which test is applied, the courts must first examine the purpose of the rule to determine whether a cause of action should properly lie for its violation.[96] It is submitted that a NYSE rule should be actionable when its central purpose is to protect the interests of the investing public *and* where it is reasonable to assume that the Commission had refrained from exercising its own rulemaking authority[97] because it felt that the public was being adequately protected by the regulatory scheme established by the NYSE.[98] In order to apply this test, it will be necessary for the courts to determine in each case whether the NYSE rule in issue is in fact a substitute for a rule of the Commission. One commentator has suggested that this determination could be made by the Commission itself — the Commission could issue public releases setting forth its position with respect to future rules and could likewise clarify the status of NYSE rules presently in effect.[99] Another suggested test indicates that a self-

95. *See* notes 55–59 and accompanying text *supra.*

96. *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966).

97. Section 11 of the Exchange Act authorizes the Commission to prescribe rules regulating specialists' activities and floor trading by members for their own account. *See* 15 U.S.C. § 78k (1970). The Commission has only issued two rules under this section, SEC Rule 11a-1, 17 C.F.R. § 240.11a-1 (1976) (regulation of floor trading), and SEC Rule 11b-1, 17 C.F.R. § 240.11b-1 (1976) (regulation of specialists). Section 14(b) authorizes the Commission to promulgate rules governing the voting by broker-dealers of street name securities registered on an exchange or under section 12(g), 15 U.S.C. § 78*l*(g) (1970), and the transmission of materials to the owners of such securities. *Id.* § 78n(b) (1970). The Commission has not yet issued any rules under this section.

98. This suggested test is actually a variation of the *Colonial* substitution rule. Although it is important to give some consideration to whether the rule in question was designed for the public benefit, the standard of "investor protection," standing alone, is much too ambiguous to provide a sound basis for discriminating between those rules which should and those which should not be actionable.

99. *See* Hoblin, *supra* note 68, at 277. This author also noted that the courts would have an easier time determining which NYSE rules were actionable if the NYSE were to follow his proposed guidelines in enacting its rules:

1. These rules should be divided into logical categories. As the court pointed out in *Buttrey,* rule 405 contains many "housekeeping" requirements which are not properly part of the "Know Your Customer" rule. One suspects, going a step further, that actually some of the New York Stock Exchange rules seem to have been used solely as a convenient depository for new ideas.
2. The purpose and history of a rule should be set forth in much the same way as a federal statute is defined.
3. The rules should be annotated reflecting civil decisions such as *Buttrey* and the Exchange's own determinations, including disciplinary proceedings which are precedent setting.
4. The Exchange should prepare guidelines for its Department of Member Firms and for arbitrators. In the case of the former, the guide rules should be in the form of a "table of maximum punishments;" for the latter, they should be designed to assist in determining monetary liability to the public for rule violation.
5. The Exchange should carefully consider the legal impact of any rules proposed in the future. An example would be a rule permitting the Exchange to deny counsel to a member or employee of a member at a disciplinary proceeding.

regulatory requirement is a direct substitute for a Commission rule when: 1) a Commission rule expressly exempts persons from its requirements because of the existence of a NYSE rule found adequate by the Commission; or 2) the Commission promulgates a rule imposing requirements similar to those imposed by a NYSE rule and limits the rule's applicability to nonmembers or unlisted companies.[100]

Irrespective of the test adopted, it is imperative that civil liability be implied only for rules with quite explicit content; general rules merely requiring adherence to "just and equitable principles of trade"[101] are an inadequate basis for implied causes of action since their ambiguity cannot provide a court with useful guidelines for establishing the standard of care to be met in each case. Judicial determinations that violations of these general rules were actionable undoubtedly would lead to disruptive consequences and would hardly serve to further the scheme of investor protection envisioned by the Exchange Act.[102]

> Another example would be the Exchange requiring under rule 405 that a copy of a corporate charter be obtained for all corporate margin accounts.
>
> 6. A general counsel's office should be established at the New York Stock Exchange, one of its responsibilities being to give official rule interpretations. Another responsibility would be to see to it that the Exchange participates in civil proceedings where appropriate, as outlined below.

Id. at 279 (footnote omitted).

Another issue related to the manner in which NYSE rules are currently adopted was raised in the case of DeRenzis v. Levy, 297 F. Supp. 998 (S.D.N.Y. 1969). In that derivative action, the court refused to uphold a private cause of action against a NYSE member firm for violation of a section of NYSE Rule 440, which provides that fees for investment advisory services cannot be based upon the profits realized from the transaction. NYSE Rule 440A.11, *reprinted in* NYSE GUIDE, *supra* note 10, at 3781-3 to -4. The court's ruling was predicated upon its determination that the rule in question was in conflict with both the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1970), and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1970). The court, in dicta, next addressed what it termed the

> potentially troublesome questions as to the constituency and the procedures which give birth to exchange rules . . . . [E]ven public officials making "legislative" enactments of any public consequence should be bound to at least minimal standards of notice and an opportunity for people affected to be "heard" in some rudimentary way . . . . This is not a concern, of course, when the promulgating exchange itself is being called upon to obey or enforce its own rules and regulations. The problem becomes more troublesome, however, when it is proposed that such rules should define valuable rights and costly liabilities for members of the exchange and people dealing with them . . . .

297 F. Supp. 998, 1001-02 n.5 (citations omitted).

100. *See* Shipman, *supra* note 52, at 1007. The author asserts that this approach would have several advantages, namely, "[i]t is easy to apply, supplies the maximum predictability, and comprehends the fewest self-regulatory requirements." *Id.* at 1007-08. For a critical analysis of this test, *see* Hoblin, *supra* note 68, at 277-78.

101. An example of such a rule is NYSE Rule 401, adopted by the NYSE pursuant to section 6(b) of the Exchange Act, 15 U.S.C. § 78f(b) (1970). For a discussion of rule 401, *see* note 48 *supra*. For a discussion of section 6(b), *see* text accompanying note 6 *supra*.

102. *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182-83 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966).

V. IMPLIED LIABILITY OF LISTED COMPANIES: CONFLICT BETWEEN DISCLOSURE UNDER THE LISTING AGREEMENT AND DISCLOSURE UNDER RULE 10b-5.

Courts have implied a private cause of action for damages under rule 10b-5[103] ever since *Kardon v. National Gypsum Co.*[104] was decided in 1946.[105] In order to prevail in an implied 10b-5 action, plaintiff must establish the existence of several elements of proof:[106] 1) the purchaser-seller standing requirement; [107] 2) scienter;[108] 3) reliance;[109] and 4) causation.[110] One of the policies underlying the disclosure requirements of rule 10b-5 is making "material" information equally available to the investing

103. 17 C.F.R. § 240.10b-5 (1976). For the text of rule 10b-5, *see* note 21 *supra.*

104. 69 F. Supp. 512 (E.D. Pa. 1946); *see* notes 24 & 25 and accompanying text *supra.*

105. The Supreme Court did not consider this question until 1971. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). This action was brought under the federal securities acts by the state superintendent of insurance, acting as liquidator of an insurance corporation, to recover damages sustained by the corporation when it sold almost five million dollars of United States treasury bonds through the alleged fraud of outside collaborators, a corporate officer, and its controlling shareholder. *Id.* at 7-9. The Court held that the corporation was the seller of treasury bonds and was therefore protected by section 10(b) of the Exchange Act. *Id.* at 9. Significantly, the *Bankers Life* Court also acknowledged the existence of an implied private right of action under section 10(b). *Id.* at 13 n.9.

106. These elements closely resemble those required to establish the common law tort of deceit. *See* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 9.2 (1973).

107. Rule 10b-5 was promulgated to prevent the perpetration of fraud *"in connection with the purchase or sale* of any security." 17 C.F.R. § 240.10b-5 (1976) (emphasis added). This proscription was interpreted by the Second Circuit in 1952 as requiring that a plaintiff be an actual buyer or seller of securities in order to have standing to sue for damages under the rule. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952). The Supreme Court recently affirmed the *Birnbaum* rule in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

108. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court held that scienter is a necessary element in a 10b-5 action. *Hochfelder* involved an action brought by customers of a brokerage firm who had invested in a fraudulent securities scheme against the accounting firm which had audited the brokerage firm's books to recover damages caused by the accounting firm's alleged negligence. The Court "granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' — intent to deceive, manipulate, or defraud." *Id.* at 193 (footnote and citations omitted). The Court concluded that it would not. *Id.*

109. One limitation upon the scope of 10b-5 liability is the "requirement that there be 'reasonable' reliance upon an alleged misrepresentation and/or nondisclosure for the fraud to be actionable." Comment, *Reliance Under Rule 10b-5: Is The "Reasonable Investor" Reasonable?,* 72 COLUM. L. REV. 562, 563 (1972). For a discussion of the criteria relied upon by the courts to measure the reasonableness of reliance, *see id.* at 565-79. *See also* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (presumption of reliance in implied private actions brought under rule 10b-5 where either material nondisclosure or an impersonal effect of fraud on market prices and conditions is shown).

110. Although rule 10b-5 is silent on the requirement of causation, courts have historically required "some causal connection between one person's misconduct and another's loss" as a prerequisite to private recovery under 10b-5. A. BROMBERG, *supra* note 23, at § 8.7(1).

public and corporate insiders.[111] Thus, a corporation and its insiders are obligated to disclose to their "outside" purchasers or sellers all "material facts" relevant to the transaction being consummated.[112] If the insider is unable to make this disclosure due to his responsibility to the corporation not to reveal prematurely certain information,[113] his only option is to refrain from trading.[114]

The NYSE likewise requires its listed companies to make "timely and adequate disclosure" of certain "corporate news."[115] Although this command appears to duplicate the mandate of rule 10b-5, the two rules differ in one important respect: while to date the 10b-5 disclosure requirement has been invoked only when there has been actual corporate or insider trading on the basis of inside knowledge,[116] the NYSE's requirement is applicable even in the *absence* of such trading.[117] The NYSE additionally obligates its issuers to give "immediate publicity and immediate notice to the [NYSE] in respect of any corporate action . . . which will result in,

111. *See* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 at § 6.01 (1974).

112. *See* note 111 and accompanying text *supra.*

113. In discussing this 10b-5 duty of disclosure, Professor Loss stated that "[c]onflict is inevitable between the insider's 10b-5 duty to the other party to the transaction to disclose 'material' facts and the common law duty he will often have to the company *not* to make premature disclosure." 6 L. Loss, *supra* note 27, at 3588.

114. *Id.* at 3590.

115. *See* NYSE MANUAL, *supra* note 11, at A-18 to -20. The Manual provides:

> A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange . . . .
>
> A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

Id. at A-18.

116. *But see* Financial Indus. Fund v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973). In this 10b-5 action for damages, brought by a mutual fund against McDonnell Douglas Corporation (Douglas) and the underwriter of Douglas, Merrill Lynch, Pierce, Fenner & Smith, Inc., the United States Court of Appeals for the Tenth Circuit recognized in dicta that a corporation may be held liable for nondisclosure in the absence of trading. *Id.* at 521.

Although the plaintiff in this case did not successfully meet its burden of proof, the court articulated what a plaintiff must prove in order to prevail in a nondisclosure case:

> To prevail the plaintiff in this silence case had the burden of proof to establish that it exercised due care in making its stock purchase, that the defendant failed to issue the special earnings statement when sufficient information was available for an accurate release (or could have been collected by the exercise of due diligence), and to show there existed a duty owed by the defendant to the plaintiff to so disclose as to do otherwise would be a violation of Rule 10b-5, and upon inaction under such showing plaintiff relied to its detriment. The defendant as a separate defense could show either good faith or the exercise of good business judgment in its acts or inaction.

Id. at 521.

117. For a discussion of the 10b-5 disclosure requirements, *see* notes 109-12 and accompanying text *supra.* For a discussion of the NYSE's disclosure requirements for listed companies, *see* note 113 and accompanying text *supra.*

or which looks toward, the redemption of a listed security . . . ."[118] In certain cases the NYSE will allow a company to refrain from disclosing material information.[119] However, companies permitted to pursue a course of nondisclosure must carefully confine their secret negotiations to a small group of top management officials.[120]

The question presented by the coexistence of these two sets of disclosure requirements is whether a cause of action may lie for a violation of the listing agreement when this infraction is not likewise violative of rule 10b–5.[121] In *Van Gemert v. Boeing Co.,*[122] a recent case imputing civil liability to an issuer for violating his listing agreement with the NYSE, the Second Circuit granted plaintiffs standing to assert their claim despite the fact that they did not also assert an implied 10b–5 action for damages.[123] If future courts follow the precedent established by *Van Gemert,* implied rights of action for breaches of the NYSE listing agreement could conceivably become vehicles for the expression of those "vexatious" claims condemned by the Supreme Court in a recent decision.[124] Nevertheless, judicial recognition of this form of implied action would undoubtedly provide assurance that plaintiffs with colorable claims would not be denied access to federal courts merely because they were not purchasers or sellers within the meaning of rule 10b–5.[125] It is submitted that the most equitable manner of resolving this complex issue would be for courts to apply a balancing test in each individual case, weighing the policy of investor protection against the necessity of maintaining an efficient securities market wherein listed companies and their representatives could protect their legitimate business interests with a minimal amount of unnecessary interference.

118. NYSE MANUAL, *supra* note 11, at A–170. This is the portion of the listing agreement found actionable in Van Gemert v. Boeing Co., 520 F.2d 1373, 1376 (2d Cir. 1975). *See* notes 81–89 and accompanying text *supra.*

119. *See* NYSE MANUAL, *supra* note 11, at A–19.

120. *Id.* In the event that other people become aware of the confidential information, the corporation must make an immediate public announcement. *Id.*

121. It is fairly certain that adherence to the NYSE disclosure guidelines will not protect a corporation from a successful 10b–5 suit. *See* A. JACOBS, *supra* note 111, at § 93. Professor Loss has postulated that the courts will probably treat the NYSE disclosure requirements as reinforcements to the 10b–5 obligations rather than as an upper limit on the legal responsibilities of insiders. *See* 6 L. Loss, *supra* note 27, at 3592.

122. 520 F.2d 1373 (2d Cir. 1975); *see* notes 83–91 and accompanying text *supra.*

123. 520 F.2d at 1380.

124. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court noted:

> We believe that the concern expressed for the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b–5 is founded in something more substantial than the common complaint of the many defendants who would prefer avoiding lawsuits entirely to either settling them or trying them.

Id. at 740.

125. Even the *Blue Chip Stamps* Court recognized that some plaintiffs with actual injuries were excluded from the federal courts by the operation of the *Birnbaum* rule. *Id.* at 743.

Denbo: Implication of Civil Liability under the New York Stock Exchange

VI. CONCLUSION

In an effort to effectuate the underlying purpose of the Exchange Act — protection of investors — the judiciary has often permitted private rights of action to lie for violations of the rules or listing agreements of the national stock exchanges. Despite the fear of some that the implication of civil liability would have a disruptive effect on the securities market, it has proven to be a resourceful method of implementing the congressional design. At present, most courts hold actionable only those rules which are specific, designed for the public benefit, and a substitute for rules of the Commission. As long as these judicially created safeguards remain in force, it is unlikely that the process of implication will subject the exchanges to unlimited liability. Rather, it will surely foster achievement of the goal of an honest and efficient system of securities regulation, one in which the investing public can justifiably have confidence.

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