Denver Law Review

Volume 55
Issue 3 *Tenth Circuit Surveys*

Article 12

February 2021

Securities

John L. Ruppert

SECURITIES

OVERVIEW

During the past term, the Tenth Circuit Court of Appeals reviewed five decisions[1] brought under the federal securities laws.[2] Of these five decisions, *Utah State University of Agriculture and Applied Science v. Bear, Stearns & Co.* was the most important.[3] The following comment will focus exclusively on the *Utah State University* decision.

IMPLIED PRIVATE RIGHTS OF ACTION FOR VIOLATION OF EXCHANGE, ASSOCIATION, AND FEDERAL RESERVE BOARD RULES

In *Utah State University of Agriculture and Applied Science v. Bear, Stearns & Co.*,[4] the plaintiff-University brought eight companion appeals from judgments dismissing actions against various brokerage houses for losses sustained in certain securities transactions.[5] In the district court, the plaintiff had presented

---

[1] Pollution Control & Eng'r Corp. v. Lange, No. 76-1338 (10th Cir., July 11, 1977) (Not for Routine Publication) (a discussion of the elements of section 10(b)); Chandler v. Kew, Inc., No. 76-1083 (10th Cir., April 19, 1977) (Not for Routine Publication) ("economic reality" of the sale of all the stock was a sale of a business not a security); SEC v. American Commodity Exch., Inc., 546 F.2d 1361 (10th Cir. 1976) (naked commodity options are securities but are governed by the CFTC); Ballard & Cordell Corp. v. Zoller and Danneberg Explor., Ltd., 544 F.2d 1059 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977) (fractional oil and gas interests offered in their entirety are not securities).

[2] *See* Securities Act of 1933, 15 U.S.C. § 77a-aa (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78a-jj (1970).

[3] 549 F.2d 164 (10th Cir.), *cert. denied*, 98 S. Ct. 264 (1977).

[4] *Id.*

[5] Utah State University (USU) is a land grant university operating under the Constitution of the State of Utah. The defendants in the lower court suits were (1) Bear, Stearns & Co., (2) Blyth Eastman Dillon & Co., (3) Bosworth, Sullivan & Co., (4) Hornblower & Weeks - Hemphill, Noyes, Inc., (5) Shearson, Hammil & Co., (6) Sutro & Co., (7) Merrill Lynch, Pierce, Fenner & Smith, Inc. All of these brokerage firms were members of the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD). In 1972, the governors of USU adopted a resolution allowing USU to maintain brokerage accounts, with two named officers to act thereunder by resolution. The resolution was to remain in effect until notice of termination was delivered to the brokers. During the subsequent year, Catron, one of the named officers, opened various accounts. The assistant attorney general of Utah declared that some of Catron's securities transactions were illegal. USU ordered Catron to stop purchasing securities. Catron did not stop until four months later when USU sent notice of revocation of Catron's authority to the brokerage firms. USU filed suit against the brokers to recover its losses. *Id.* at 165-67.

It must be emphasized at the outset, that the rules and statutes, as analyzed in this

three alternative arguments in support of recovery: (1) Violations of rules 405 and 411 of the New York[6] (NYSE) and American Stock (AMEX) Exchanges,[7] and violations of the National Association of Securities Dealers (NASD) Rules of Fair Practice;[8] (2) violations of Regulation T of the Federal Reserve Board;[9] and, (3) violation of section 10(b),[10] the antifraud provision of the Securities Exchange Act of 1934.[11] The district court dismissed the first and second claims on the grounds that no implied private right of action existed for violation of such rules. The court also found that the plaintiff failed to support his section 10(b) claim.[12] On appeal, the Tenth Circuit affirmed the trial court's decision, although it rejected the district court's position that violation of exchange and association rules *never* gives rise to a private cause of action.

---

comment, are those that were effective during the period under examination. No attempt is made to analyze the impact of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975). The impact of the Act on the area of SEC supervision of exchange and association promulgation of rules is expected to be far-reaching. *See* Castruccio & Tischler, *Developments in Federal Securities Regulation—1975*, 31 BUS. LAW. 1855, 1884-85 (1976); Rowen, *The Securities Acts Amendments of 1975: A Legislative History*, 3 SEC. REG. L.J. 329 (1976). The Supreme Court's mode of analysis should remain the same, however, whether one is looking at implied private rights of action before or after the 1975 Act.

[6] Rule 405 provides, "Every member organization is required . . . to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account . . . and every person holding power of attorney over any account accepted or carried . . . ." Rule 405, *reprinted in* [1973] 2 N.Y. STOCK EXCH. GUIDE (CCH) ¶ 2405.

[7] Rule 411 is the American Stock Exchange's equivalent to NYSE Rule 405. *See* [1973] 2 AM. STOCK EXCH. GUIDE (CCH) ¶ 9431.

[8] Article III, Section 2 of the NASD Rules of Fair Practice requires that:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NASD Rules of Fair Practice, Art. III, § 2, [1976] NASD MANUAL (CCH) ¶ 2152.

[9] Regulation T concerns the extension of credit by brokers and dealers to their customers. *See* 12 C.F.R. § 220.1-.130 (1977). Pursuant to 15 U.S.C. § 78g(f) (1970), regulation X was also promulgated. *See* 12 C.F.R. § 224.1-.6 (1977). Regulation X makes it illegal for a customer to obtain, receive, or enjoy credit in violation of Federal Reserve Board Regulations. *Id.* § 224.1.

[10] 15 U.S.C. § 78j(b) (1970).

[11] The plaintiff's complaint also alleged various pendent claims under state laws, but no questions were raised on appeal concerning these matters. 549 F.2d at 166-67.

[12] 549 F.2d at 167.

This comment will examine two rather disturbing aspects of the *Utah State University* decision. First, the court appears to have confused the very subtle but basic distinction between the concepts of creating an implied private right of action and defining or identifying the elements of that action. Second, the method of analysis employed by the court in its examination of the "Know Your Customer"[13] and "Suitability"[14] rules is so noticeably dissimilar from the analytical framework employed by the Supreme Court in recent securities law opinions that the precedential value of *Utah State University* is highly suspect.

This comment will focus on these two questions and will discuss the Tenth Circuit's analysis of the section 10(b) question only with respect to its impact on the court's analysis of the exchange and association rules. To adequately understand the analytical framework in the *Utah State University* decision, one must examine the divergent lines of the development case law.

I. NYSE, AMEX, AND NASD RULES: IMPLIED PRIVATE RIGHTS OF ACTION

The issue of whether violations of exchange and association rules give rise to an implied private right of action is a relatively recent concern.[15] The federal courts have come to differing, often opposite, conclusions during this issue's short eleven-year his-

[13] "Know Your Customer" has become the accepted title of rule 405 of the NYSE and rule 411 of the AMEX, *supra* notes 6 and 7. For a discussion of these rules see Hoblin, *Stock Broker's Implied Liability to its Customer for Violation of a Rule of a Registered Stock Exchange*, 39 FORDHAM L. REV. 253 (1970); MacLean, *Brokers' Liability for Violation of Exchange and NASD Rules*, 47 DEN. L.J. 63 (1970); Wolfson and Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CAL. L. REV. 1120 (1970); Comment, *The "Know Your Customer" Rule of the NYSE: Liability of Broker-Dealers Under the UCC and Federal Securities Laws*, 1973 DUKE L.J. 489.

[14] The "Suitability rule" has become a shorthand phrase for Art. III, § 2 of the NASD Rules of Fair Practice. *See* note 8 *supra*. For a general discussion of the rule see Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445; Rediker, *Civil Liability of Broker-Dealers Under SEC and NASD Suitability Rules*, 22 ALA. L. REV. 15 (1969); Note, *Implied Civil Liability Arising From Violation of the Rules of the National Association of Securities Dealers*, 8 LOY. L.A.L. REV. 151 (1975); Comment, *Civil Liability for Violations of NASD Rules*, SEC v. First Securities Co., 121 U. PA. L. REV. 388 (1973).

[15] The development of this issue began with the decision of Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). In *Colonial Realty*, Judge Friendly traced the development in earlier decisions of a related question, implied civil liability of a stock exchange for failure to enforce rules adopted pursuant to section 6(b) of the Securities Exchange Act. *Id.* at 181.

tory.[16] Although the courts have applied or developed many different "legal tests" to apply to the facts before them, all of these tests appear to be variations on, or hybrids of, two decisions of the late 1960's.

The first test was formulated by Judge Friendly in the 1966 decision, *Colonial Realty Corp. v. Bache & Co.* In *Colonial Realty,*[17] the plaintiff urged that violations of Article III, section 1 of the NASD Rules of Fair Practice[18] afforded an investor an implied private right of action. The court qualified its rejection of the plaintiff's argument by noting:

> [W]hether the courts are to imply federal civil liability for violation of exchange or dealer . . . rules . . . cannot be determined on the simplistic all-or-nothing basis. . . . [T]he court must look to the nature of the particular rule and its place in the regulatory scheme . . . . The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. The rules here at issue, however, are near the opposite pole.[19]

---

[16] The federal courts have split on the issue of whether exchange and association rules may give rise to an implied private right of action. For a discussion of why such an action has been rejected see Sanders v. John Nuveen & Co., 554 F.2d 790, 796-97 (7th Cir. 1977); Carras v. Burns, 516 F.2d 251, 260 (4th Cir. 1975); Nelson v. Hench, 428 F. Supp. 411, 418-20 (D. Minn. 1977); Parsons v. Hornblower & Weeks-Hemphill Noyes [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,885, at 91,249-50 (M.D.N.C. Feb. 9, 1977); Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,809-13 (N.D. Cal. Sept. 27, 1976); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 889-90 (D. Conn. 1976); Jenny v. Shearson, Hammill & Co., [1974-1975] FED. SEC. L. REP. (CCH) ¶ 95,021, at 97,581-82 (S.D.N.Y. March 11, 1975); Utah v. duPont Walston, Inc., [1974-1975] FED. SEC. L. REP. (CCH) ¶ 94,812 at 96,715 (D. Utah Oct. 1, 1974); Golob v. Nauman Vandervoort, Inc., 353 F. Supp. 1264, 1266 (N.D. Ohio 1972).

For decisions recognizing that violations of exchange or association rules may give rise to a private cause of action, see Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 160 (8th Cir. 1977); Lincoln Commodity Services v. Meade, 558 F.2d 469, 474 (8th Cir. 1977); Ocrant v. Dean Witter & Co., 502 F.2d 854, 858 (10th Cir. 1974); Faturik v. Woodmere Securities, Inc., 431 F. Supp. 894, 896-97 (S.D.N.Y. 1977); Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1040-41 (S.D.N.Y. 1977); Evans v. Kerbes & Co., 411 F. Supp. 616 (S.D.N.Y. 1976); Architectural League v. Bartos, 404 F. Supp. 304, 314 (S.D.N.Y. 1975); NYSE v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975).

These cases represent only a limited survey of the judicial responses to the implied private right of action issue. See notes 13 and 14 *supra* for a discussion of these general concepts.

[17] 358 F.2d 178 (2d Cir.), *cert. denied,* 385 U.S. 817 (1966).

[18] *Id.* at 180. This section of the NASD Rules of Fair Practice provides that "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." NASD Rules of Fair Practice, Art. III, § 1, NASD MANUAL (CCH) ¶ 2151 (1973).

[19] 358 F.2d at 182.

Judge Friendly reached this conclusion by an analysis of certain factors which had been developed in past cases examining the potential existence of an implied private right: (1) whether an explicit condemnation of certain conduct existed, (2) whether a general grant of jurisdiction to enforce the liabilities created by the statute could be found, (3) whether a duty to effectuate the federal policies of the Act were present, and (4) whether existing judicial and administrative remedies to effectuate those policies had proven ineffective.[20] Superimposed upon this analytical framework was Judge Friendly's additional concern for the potential impact that the recognition of implied civil liability might have on the self-regulatory plan formulated by Congress for brokers and dealers.[21]

The second bellweather test was formulated by Judge Cummings in 1969, in *Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*[22] Purporting to apply the *Colonial Realty* test[23] to the question of whether violations of the "Know Your Customer" rule gave rise to an implied private right of action, Judge Cummings, in effect, fashioned a new two-element test, requiring consideration only of whether the particular rule in question "was designed for the direct protection of investors," and whether the particular defendant's conduct had been "tantamount to fraud."[24] Qualifying this test by noting that a violation of the "Know Your Cus-

[20] *Id.* at 181. The court found these factors to have been decisive in J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964), Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951), and Baird v. Franklin, 141 F.2d 238, 244-45 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), (all dealing with implied private rights of action under various provisions of the federal securities laws).

[21] *See* 358 F.2d at 182-83. The self-regulatory nature of exchanges and associations was amply supported by the recent congressional statement that "[t]he self-regulatory roles of the exchanges and the NASD have been major elements of the regulatory scheme of the Exchange Act since 1934 and 1938, respectively." SECURITIES ACTS AMENDMENTS OF 1975, S. REP. No. 75, 94th Cong., 1st Sess. 23, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 179, 201. *See also* REPORT OF SPECIAL STUDY OF THE SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. DOC. No. 95 Pt. 4, 88th Cong., 1st Sess. (1963). In Silver v. NYSE, 373 U.S. 341, 349-61 (1963), the Supreme Court went to some lengths to discuss the self-regulatory scheme devised by Congress.

[22] 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

[23] *Id.* at 142. Judge Cummings quoted the specific language of the *Colonial Realty* opinion that may be found in the text accompanying note 19 *supra*. In addition, Judge Cummings noted that "[s]uch a breach of fair practice undermines the protection of investors and surely 'play[s] an integral part in SEC regulation' of Exchanges and their members. Colonial Realty Corp. v. Bache & Co. . . . (citation omitted)."

[24] *Id.* at 142-43.

tomer" rule was not *per se* actionable, Judge Cummings believed that the conduct before him was sufficient to give rise to an implied private right of action.[25]

As noted earlier, the federal courts have split, both in the results they have reached on this issue and in the "legal test" they have applied.[26] The courts within the Tenth Circuit have fared no better in their analysis of the problem.

The first federal court within the Tenth Circuit to address the issue of whether violations of exchange and association rules give rise to an implied private right of action was the tenth Circuit Court of Appeals itself in *Ocrant v. Dean Witter & Co.*[27] In dictum, Judge Seth cited the *Buttrey* decision with approval, and noted: "[W]hile we recognize that in an appropriate case, violations of exchange rules designed for customer protection might give rise to a private cause of action . . . such a case is not now before us."[28] Without mentioning the second "tantamount to fraud" element of the *Buttrey* test, or the reason for the court's adoption of the *Buttrey* test over the *Colonial Realty* test, the court resolved the case on traditional agency law principles.[29]

One month after *Ocrant,* in October of 1974, the Utah Federal District Court rejected an implied private right of action for violation of the "Know Your Customer" and "Suitability" rules. Without any mention of *Ocrant,* Judge Anderson, writing for the court in *Utah v. duPont Walston, Inc.*,[30] relied solely on Judge Friendly's analytical framework in *Colonial Realty.*[31] The court,

---

[25] *Id.* at 142. It is interesting to note that what may have been envisioned as merely a variation of the *Colonial Realty* test in the *Buttrey* decision has come to be viewed as a separate and totally distinct test. *See* Landy v. FDIC, 486 F.2d 139, 164-66 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974); Nelson v. Hench, 428 F. Supp. 411, 418-19 (1977), Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,807-09 (N.D. Cal. Sept. 27, 1976). *See also,* Hoblin, *supra* note 13, at 258-66; MacLean, *supra* note 13, at 66-71; Wolfson and Russo, *supra* note 13, at 1126-33.

[26] *See* notes 13-16, 25 *supra.*

[27] 502 F.2d 854 (10th Cir. 1974).

[28] *Id.* at 858.

[29] *See* note 24 *supra* and accompanying text. Subsequently *Ocrant* has been cited for the proposition that the violation of certain exchange rules may give rise to an implied private right of action. *See, e.g.,* Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. at 1040; Evans v. Kerbs & Co., 411 F. Supp. 616, 621 (S.D.N.Y. 1976); Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) at 90,808.

[30] [1974-1975] FED. SEC. L. REP. (CCH) ¶ 94,812 (D. Utah, Oct. 1, 1974).

[31] *Id.* at 96,714-15. The plaintiff alleged violations of Art. III, §§ 1, 2 of the NASD Rules of Fair Practice, rule 405 of the NYSE, and rule 411 of AMEX. It is interesting to

only briefly adverting to the Seventh Circuit *(Buttrey)* rule, rejected the *Buttrey* test and adopted *Colonial Realty* on the grounds that the latter better differentiated between mere ethical standards of professional service and rules designed to prevent fraud.[32]

This rejection was followed, in time, by the Wyoming District Court's recognition of an implied private right of action for violation of the "Know Your Customer" and "Suitability" rules in *Geyer v. Paine, Webber, Jackson, and Curtis, Inc.*[33] In contrast to *State of Utah,* Judge Kerr, in *Geyer,* relied almost exclusively upon the *Ocrant* and *Buttrey* decisions.[34] Citing *Mercury Investment Co. v. A.G. Edwards & Sons,*[35] Judge Kerr distinguished *Colonial Realty* on the grounds that that decision involved a violation of Article III, section 1 of the NASD rules rather than rule 405. In a perceptive analysis of *Colonial Realty,* the court noted that Judge Friendly had not rejected an implied private right of action for violation of all exchange or association rules, but rather had rejected such actions only for those "catch-all" rules based on vague adjurations of general forms of conduct.[36] Relying heavily on the *Buttrey* analysis, Judge Kerr termed Article III, section 1 of the NASD rules a "house-keeping" rule as opposed to a specific rule creating a duty on the part of brokers to directly protect investors from fraudulent conduct.[37] In the *Geyer* opinion,

---

note that the court erroneously adopted the *Colonial Realty* test based on its interpretation that the test would give rise to an implied private action only when fraud was proved. *Id.* The court never discussed why the same was not true for the *Buttrey* test, especially in view of its "tantamount to fraud" second element.

[32] *Id.* at 96,715.

[33] 389 F. Supp. 678 (D. Wyo. 1975).

[34] *Id.* at 683.

[35] 295 F. Supp. 1160, 1162 (S.D. Tex. 1969). The Texas court noted: "*Colonial* did not issue a blanket holding that such dealer rules could never give rise to federal civil liability."

[36] The court noted that in contrast to Art. III, § 1 of the NASD Rules of Fair Practice, the "Know Your Customer" and "Suitability" rules were "quite precise" and had "among their purposes the protection of the investing public." 389 F. Supp. at 683. Art. III, § 1, in contrast merely precluded conduct "inconsistent with just and equitable principles of trade." *See* note 18 *supra.*

[37] 389 F. Supp. at 683. The court stated that the Securities Acts, "although designed to protect the investor, are essentially directed at fraud. In holding that the rules in dispute are actionable, the Court does not mean to imply that mere negligence . . . will suffice to sustain an action . . . ." *Id.*

the "Know Your Customer" and "Suitability" rules were found to fall into the latter category.[38]

In *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Western District of Oklahoma held the "Know Your Customer" rules to be nonactionable by a private investor.[39] Without any discussion in the opinion of the case law behind this issue, Judge Eubanks granted defendant's motion for summary judgment after plaintiff *conceded* the nonactionability of the rule in question.[40]

The most recent attempt by a court within the Tenth Circuit to resolve the issue of whether violations of the NASD's "Suitability" rule give rise to an implied private right of action occurred in *Marshak v. Blyth Eastman Dillon & Co., Inc.*, a Northern District of Oklahoma decision.[41] Again without any discussion of the case law, Judge Cook simply noted that the plaintiff had failed to demonstrate even negligence on the part of the broker-defendant, or that the broker's conduct was the proximate cause of plaintiff's loss. The plaintiff's allegation that the defendant had made an unsuitable investment was therefore denied.[42]

From this extremely weak intra-circuit district court line of analysis, the Tenth Circuit attempted to resolve the lower court split in *Utah State University*. Following is discussion of Judge Breitenstein's analysis.

II. UTAH STATE UNIVERSITY

A. *Exchange and Association Rules*

After recognizing the split existing in the Tenth Circuit as a

---

[38] *Geyer* was cited with approval in Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. at 1041. The *Geyer* decision was criticized in Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. at 890, where the court noted: "While the SEC's view of a broker-dealer's duty to supervise his employees is certainly of some significance, adoption of a rule imposing stringent standards of conduct does not lead ineluctably to the conclusion that a federal court ought to create the basis for a lawsuit in damages for breach of that rule."

[39] 401 F. Supp. 111, 112 (W.D. Okla. 1975).

[40] There is no indication in the opinion as to why the plaintiff conceded this highly questionable issue. *Thompson* has only been cited twice since it was decided, but neither subsequent case discussed the actionability of exchange rules. *See* Franke v. Midwestern Okl. Development Authority, 428 F. Supp. 719, 723 (W.D. Okla. 1976); Vacca v. Intra Mgmt. Corp., 415 F. Supp. 248, 250 (E.D. Pa. 1976).

[41] 413 F. Supp. 377 (N.D. Okla. 1975).

[42] Id. at 384. The *Marshak* decision has not been cited in any subsequent decision.

result of the decisions discussed above,[43] Judge Breitenstein disposed of the implied private right of action issue in summary fashion:

> In *Ocrant* . . . , by way of dicta, and citing *Buttrey*, we recognized that "in an appropriate case, violations of exchange rules *designed for customer protection* might give rise to a private cause of action . . . ."
>
> The statement in *Ocrant* is pertinent. In an appropriate case a rule violation may give rise to a private cause of action.
>
> . . . .
>
> Applying the statements of the Court to claims asserted under association and exchange rules, something more than mistake or negligence must be shown . . . . The allegations, taken separately or together, are not *Tantamount to fraud.*[44]

Without expressly so stating, the Tenth Circuit adopted the *Buttrey* test *in toto.*[45] It is different to determine from reading the opinion, however, whether the court felt compelled to include the "tantamount to fraud" element in its analysis because of the Seventh Circuit's holding in *Buttrey*, or the recent Supreme Court decision of *Ernst & Ernst v. Hochfelder*,[46] or both.[47]

Two criticisms may be leveled at Judge Breitenstein's mode of analysis. First, there is little guidance in *Utah State University*, for distinguishing rules "designed for customer protection" from those rules aimed at accomplishing other purposes. One could take the position that, all the rules of exchanges and associations exhibit *some* degree of concern for the "protection of

---

[43] 549 F.2d at 168.

[44] *Id.*

[45] *See* text accompanying note 24 *supra.*

[46] 425 U.S. 185 (1976).

[47] The "tantamount to fraud" element has been a prominent aspect of many decisions applying the *Buttrey* test. Carras v. Burns, 516 F.2d 251, 260 (4th Cir. 1975). *See, e.g.*, Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 160. The Tenth Circuit, however, has never cited this element as mandated by the *Buttrey* test. *See* notes 38, 31, and accompanying text *supra. See* the discussion of *Ocrant*, text accompanying note 28 *supra.*

In contrast to the lack of any mention of *Buttrey*, Judge Breitenstein devoted extensive space to *Ernst & Ernst*, citing the legislative history behind the Supreme Court's position that conduct is actionable under section 10(b) only if fraudulent. 549 F.2d at 168. This analogy is highly suspect, however, for Congress had no intentions regarding the purpose and scope of rules promulgaed by an exchange or association. A counter argument can even be made that to make only fraudulent conduct actionable under exchange and association rules would be merely duplicative of section 10(b). *See* Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) at 90,812; Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1383 (N.D. Tex. 1976).

customers."[48] If this is so, the Tenth Circuit has made no attempt to identify those factors which will help in determining the actionability of a specific rule.

Perhaps, this failure to identify such criteria is more a shortcoming of the *Buttrey* test, itself, than something peculiar to the Tenth Circuit.[49] An example of the guidance that could have been offered by the *Utah State University* decision may be found in *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*[50] In that opinion Judge Kerr attempted to distinguish "house-keeping rules," such as the composition and election of the board of governors, transfers of memberships, dues and other fees, registration of floor employees, and back-office procedures, from those rules promulgated by organizations for the *direct* protection of customers from fraudulent conduct.[51] Even the *Geyer* court's analysis is questionable if one notes that the Report of the Special Study of Securities Markets of the Securities Exchange Commission found the "Know Your Customer" rules to have been designed primarily to protect *member firms* against irresponsible customers.[52] Based on

---

[48] *See generally* Allen, *Liability Under the Securities Exchange Act For Violations of Stock Exchange Rules*, 25 BUS. LAW. 1493, 1501 (1970); Wolfson and Russo, *supra* note 13, at 1130; Comment, *Civil Liability For Violation of NASD Rules: SEC v. First Securities Co.*, 121 U. PA. L. REV. 388, 393 (1972).

[49] In *Buttrey*, the Seventh Circuit did refer fleetingly to the trial court's discussion of nonactionable housekeeping rules, but the circuit court failed to expand on this. 410 F.2d at 141. Other commentators have attempted to identify the element distinguishing actionable from non-actionable exchange and association rules. *See, e.g.*, Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. at 1040-41 (rules must be sufficiently precise); Allen *supra* note 48, at 1500; Hoblin, *supra* note 13, at 274-79; MacLean, *supra* note 13, at 76; Wolfson and Russo, *supra* note 13, at 1135-1141; Comment, *The "Know Your Customer" Rule of the NYSE: Liability of Broker-Dealers Under the UCC and Federal Securities Laws*, 1973 DUKE L.J. 489, 547-48.

[50] 389 F. Supp. 678 (D. Wyo. 1975). For a discussion of the facts of *Geyer* see text accompanying notes 33-38 *supra*.

[51] 389 F. Supp. at 683. *See also* Allen, *supra* note 48, at 1500-01. Allen discusses the various forms of "housekeeping rules," *i.e.*, rules dealing with access and communication with the trading floor (NYSE Rules 35-38); making and settling exchange contracts (NYSE Rules 45-47); maintenance of market through bids and offers (NYSE Rules 61-79); handling of orders and reports (NYSE Rules 115-126); and, comparison and exchange of contracts (NYSE Rules 131-143).

[52] *See* SEC 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 316 (1963), where it was noted:

> In the study's public hearings, President Funston of the Exchange expressed the opinion that the "know your customer rule" was primarily designed to protect member firms against irresponsible customers, and the past applica-

this analysis, the "Know Your Customer" rules would, and should, fail even the *Buttrey* test.

A second ground for criticism of the *Utah State University* decision's adoption of the *Buttrey* test lies in the second element of the test, i.e., whether the defendant's conduct had been "tantamount to fraud."[53] Working from the basic premise that the primary concern is whether a particular rule is designed for customer protection, the court concluded that the defendant's conduct was not tantamount to fraud, and the plaintiff could not assert an implied private right of action. It is difficult to discern from a reading of the opinion whether the court found that no cause of action existed because the defendant's conduct was not tantamount to fraud, or that a cause of action exists but fraud is a necessary element to recovery.[54] In either instance, the failure to prove fraud will result in a denial of recovery by the plaintiff. These two methods of analysis are quite distinct, however.

The *Buttrey* test makes the presence of fraud a prerequisite to the recognition of an implied private right of action. *Zagari v. Dean Witter & Co.*, criticized such a position by noting:

> It is one thing to say as the United States Supreme Court just said in *Ernst & Ernst v. Hochfelder* . . . that while a private right

---

tion of the rule in exchange disciplinary proceedings confirms the view that it has generally been restricted to such use.

See also, Nelson v. Hench, 428 F. Supp. at 419-20; Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) at 90,813-14 n.10; Wolfson and Russo, *supra* note 13, at 1130.

[53] *See* text accompanying note 24 *supra*.

[54] *See* Hoblin, note 13 *supra*, at 267, where the author stated:

> What is the relationship between a fraud concept and that of a rule violation? No one disputes that a charge of fraud is actionable at common law or under rule 10b-5; that was not the question before the court. With respect to that count, fraud was irrelevant; either the violation of the rule was actionable or it was not. The question of fraud should not have entered into the court's consideration.

See also, Nelson v. Hench, 428 F. Supp. at 419:

> The "tantamount to fraud" requirement makes the determination concerning the private right of action depend upon individual conduct rather than upon the nature of the rule in question, with the legally illogical result that violation of the same rule would not consistently give rise to a cause of action. *See* Zagari v. Dean Witter & Co., Inc. . . . . Courts have also expressed concern that application of the *Buttrey* standard would cause excessive litigation because a determination of the facts regarding fraud would be required before subject matter jurisdiction could be determined with certainty.

See Piper Jaffray & Hopwood, Inc. v. Landin, 399 F. Supp. 292 (S.D. Iowa 1975); Lange v. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976).

> of action exists for violations of rule 10(b)-5, the rule itself is not violated unless there is evidence of scienter, and an entirely different thing to say as does the Seventh Circuit in *Buttrey*, that while rule 405 may be violated by simple errors of judgment, a private action will only lie where the rule is violated by conduct "tantamount to fraud."[55]

In contrast to the *Buttrey* form of analysis, however, the court, by its numerous references to the *Ernst & Ernst v. Hochfelder* decision,[56] may have implicitly adopted the position that an implied private right of action lies for violation of an exchange or association rule, and that fraud is a necessary element thereof.[57] This interpretation of the *Utah State University* decision may help to account for the emphasis placed by the Court on *Ernst & Ernst,* while totally ignoring the fact that "tantamount to fraud" is also the second element of the *Buttrey* test. While a close reading of the *Utah State* decision supports this latter interpretation, clarification by the court in the future would be of great assistance.

The third, and most important, ground for criticism of the Tenth Circuit's decision was the court's failure to take cognizance of the test devised by the United States Supreme Court in *Cort v. Ash.*[58] In *Cort,* the Court formulated a four-pronged test for determining whether a statute gives rise to an implied private right of action. The factors identified by the Court were: (1) Whether plaintiff was a member of the class for whose benefit the statute was passed; (2) whether Congress indicated an explicit or implicit legislative intent to grant or deny such a remedy; (3) whether an implied right of action is consistent with the legislative scheme; and, (4) whether the cause of action would be in an area of law traditionally relegated to state law.[59]

In two very recent Supreme Court opinions decided subse-

---

[55] [1976-1977] FED. SEC. L. REP. (CCH) at 90,813-14 n.11.

[56] 425 U.S. at 196. Justice Powell stated, "Although § 10(b) does not by its terms create an express civil remedy . . . the existence of a private cause of action for violations of the statute and the Rule is now well established." *But cf.* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) (the Court stated it has only recognized an implied cause of action under *some* circumstances).

[57] 425 U.S. at 196-97. Even the dissent in *Ernst & Ernst* did not view the majority's opinion as doing anything more than defining an element of a section 10(b) cause of action. *Id.* at 218.

[58] 422 U.S. 66 (1975).

[59] *Id.* at 78-85.

quent to *Utah State University* by only two months, the Supreme Court applied the *Cort* criteria to the implication of private actions under the federal securities laws. In *Piper v. Chris-Craft Industries, Inc.*,[60] the Court rejected an implied right of action for defeated tender-offerors under section 14(e) of the Securities Exchange Act of 1934. In that instance, the Court found that the tender-offeror-plaintiff failed to satisfy *any* of the four *Cort* elements.[61] In a subsequent decision, *Santa Fe Industries, Inc. v. Green,* the Court found that an alleged breach of corporate fiduciary duty, absent an allegation of fraud or misrepresentation did not violate section 10(b).[62] Part four of the *Green* opinion contains language similar to that found in the *Utah State University* decision, namely, that without proof of fraud, a breach of fiduciary duty did not *give rise to* a private cause of action under section 10(b).[63] Mr. Justice Stevens, concurring in part, aptly noted that part four was unnecessary to the decision, in light of the earlier resolution of the case on the grounds that the facts alleged by the plaintiff in his complaint did not constitute "fraud" within the meaning of section 10(b).[64] The *Green* decision, therefore, is an excellent example of the vagueness, overbreadth, and confusion also demonstrated in *Utah State University.*

At the time of the *Utah State University* decision Judge Peckham, in *Zagari v. Dean Witter & Co.,* had already recognized that in comparing the *Buttrey* and *Colonial Realty* standards, it was apparent that the former embodies only the first of the *Cort* factors.[65] In contrast, *Colonial Realty* implicitly encompassed the first factor in *Cort,* and explicitly addressed the remaining

---

[60] 430 U.S. 1 (1977).

[61] The Court examined each of the four elements of the *Cort* test, determining that: (1) The Williams Act (§ 14(e)) was enacted solely to protect investors, not tender-offerors; (2) there was no indication that Congress intended to create a private action for the loser in a tender offer contest; (3) the Williams Act was designed as a disclosure mechanism not a means for recovering monetary damages by a person outside the protection class; and (4) the common law action of interference with commercial advantages was available. *Id.* at 37-41. It is interesting to note that in coming to the opposite conclusion of the majority, the dissent also based their argument on *Cort v. Ash.*

[62] 430 U.S. 462 (1977).

[63] *Id.* at 477-80. This portion of the opinion was dictum, however, for the Court had already dismissed the plaintiff's claim for failure to prove a necessaary element of the cause of action: scienter. *Id.* at 474-77.

[64] *Id.* at 480-81.

[65] [1976-1977] FED. SEC. L. REP. (CCH) at 90,809.

three.[66] In a decision subsequent to *Utah State University, Nelson v. Hench,* the Minnesota District Court noted, "The appropriateness of Judge Friendly's approach [*Colonial Realty*] was implicitly confirmed recently by the Supreme Court in *Cort v. Ash* . . . ."[67] Numerous other courts have also attempted to resolve the implied private right of action for violation of exchange or association rules by applying the *Cort* criteria.[68]

The analysis in *Nelson v. Hench*[69] succinctly demonstrates the result obtained from an application of the *Cort* test to the "Know Your Customer" rule. Considering each element, the court noted: (1) The rule "must have been enacted primarily for the protection of the dealers . . . . [P]laintiffs . . . cannot establish . . . that the protection of investors . . . was more than an incidental motive for enactment of these rules."; (2) "[C]learly Congress did not contemplate causes of action arising under rules promulgated by exchanges or dealer associations"; (3) "Moreover, the implication of such rights of action is diametrically opposite to the concept of self-regulation that is essential to the regulatory scheme and purpose of the 1934 Act"; and, (4) "In essence, the NYSE and NASD have incorporated into their rules one standard by which defendant firms' duty could be measured in a negligence action."[70] The *Zagari* court paralleled this analysis, and in addition, noted that section 10(b) was also an available, existing remedy.[71]

To apply the *Cort* test and recognize an implied private right would require proof that under the "Know Your Customer" rule the "protection of investors" was as important, if not more impor-

---

[66] *Id.*

[67] 428 F. Supp. at 419.

[68] Numerous other opinions have also recognized the applicability of the *Cort* test to the issue of whether violations of exchange or association rules will give rise to a private cause of action. *See, e.g.,* Lank v. NYSE, 548 F.2d 61, 65 (2d Cir. 1977) (*Cort* used in the context of a suit by one exchange member against another); Hughes v. Dempsey-Tegler & Co., 534 F.2d 156, 166 (9th Cir. 1976) (pursuant to *Cort* a private action will lie against an exchange for violation of the registration provisions); Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977) (applying *Cort,* violations of margin requirements may give rise to an implied private right of action); Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1382 (N.D. Tex. 1976) (no implied private right of action for violations of NASD Rules of Fair Trade).

[69] 428 F. Supp. 411 (D. Minn. 1977).

[70] *Id.* at 419-20.

[71] [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,809-13 (N.D. Cal., Sept. 27, 1976).

tant, than the protection of brokers; the potential for implied civil liability was consistent with the regulatory scheme of the Securities Exchange Act; and, that despite a fraud requirement, the "Know Your Customer" rules still preclude conduct not actionable under presently existing theories. No plaintiff, within the framework of the *Cort* test, has attempted this argument to date.

Whether the Tenth Circuit, therefore, implicitly rejected the applicability of *Cort* to *Utah State University,* or the defendants failed to raise the issue of the *Cort* test, is unimportant. Of greater importance is the very questionability of the mode of analysis relied upon by the court.

B. *Regulation T of the Federal Reserve Board*[72]

A brief discussion of the Tenth Circuit's conclusion that a violation of regulation T (margin requirement) of the Federal Reserve Board does not give rise to a private cause of action is merited more because of the method of analysis used in that portion of the opinion than because of the result reached.[73] The issue of whether violation of regulation T should give rise to a private cause of action has been the subject of as much debate as whether violation of exchange or association rules should give rise to such a remedy. Again the federal courts have demonstrated a clearly distinguishable split both in the results they have reached and the analytical frameworks they have used.[74]

---

[72] *See* note 9 *supra.*

[73] 549 F.2d at 169-70.

[74] For an indication of the divergence in many circuits *see generally* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 156 (8th Cir. 1977); Carras v. Burns, 516 F.2d 251, 260, (4th Cir. 1975) (no cause of action created); McCormick v. Esposito, 500 F.2d 620, 627 (5th Cir. 1974), *cert. denied,* 420 U.S. 912 (1975) (no right of action); Gordon v. duPont, Glore Forgan Inc., 487 F.2d 1260 (5th Cir. 1973) *cert. denied,* 417 U.S. 946 (1974) (no action under these circumstances); Spoon v. Walston & Co., 478 F.2d 246, 247 (6th Cir. 1973) (right of action allowed); Pearlstein v. Scudder & German Co., 429 F.2d 1136, 1142-44 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971); Junger v. Hertz, Neumark, & Warner, 426 F.2d 805, 806 (2d Cir.), *cert. denied,* 400 U.S. 880 (1970); Bronner v. Goldman, 361 F.2d 759 (1st Cir.), *cert. denied,* 385 U.S. 933 (1966); Goldenberg v. Bache & Co., 270 F.2d 675, 680-81 (5th Cir. 1959) (right of action allowed); Drasner v. Thomson, McKinnon Securities, Inc., 433 F. Supp. 485 (S.D.N.Y. 1977) (no cause of action exists); Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915, 921 (D. Conn. 1977) (cause of action exists); Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) at 90,813 (rejected existence of a cause of action); Freeman v. Marine Midland Bank, 419 F. Supp. 440, 451-53 (E.D.N.Y. 1976) (discussion of regulation T and regulation X); Architectural League of N.Y. v. Bartas, 404 F. Supp. 304, 314 (no action absent showing that broker induced investor to buy); Bell v. J.D. Winer & Co., 392 F. Supp. 646,

Judge Breitenstein's analysis of the regulation T issue was markedly different from his analysis of the "Know Your Customer" and "Suitability" rules. In examining the issue, the court questioned whether the regulation was presently intended to protect investors,[75] whether an implied private action was consistent with the legislative scheme behind the regulation of margin requirements,[76] and whether criminal sanctions were available against a violating broker.[77] A closer examination of these concerns reveals that they coincide almost exactly with elements one, three, and four of the *Cort v. Ash* test.[78] Judge Breitenstein also noted that in 1970, *after* numerous cases had imposed civil liability upon brokers for violation of margin requirements, Congress amended section 7(f) of the Securities Exchange Act, making it illegal for a customer to obtain or receive credit in violation of Federal Reserve Board Regulations.[79] Therefore, the second element of *Cort*, whether Congress expressly or implicitly intended to grant or deny an implied private right of action, was indirectly addressed in *Utah State University*. Nowhere in the 1970 amendments was implied civil liability ever mentioned.[80] As with the exchange and association rules, the *Zagari*[81] court applied the *Cort* factors to its analysis of regulation T and arrived at the same conclusion as *Utah State University*.

One can only wonder why the Tenth Circuit did not apply the same analytical framework to exchange and association rules as it applied to violations of regulation T. With this in mind, therefore, it can certainly be argued that the issue of the existence

650-51 (S.D.N.Y. 1975) (duty on brokers to ensure that customers understand).

See also, Comment, *Civil Liability For Margin Violations—The Effect of Section 7(f) and Regulation X*, 43 FORDHAM L. REV. 93, 104-17 (1974); Note, *Regulation X and Investor-Lender Margin Violation Disputes*, 57 MINN. L. REV. 208 (1972).

[75] 549 F.2d at 170. (The primary purpose was to promote market stability).

[76] *Id.* (Broker is no longer the sole party responsible for observing margin requirements).

[77] *Id.* (The court noted that, although the criminal penalty depended on who the violator was, that was not grounds for imposing civil liability. As a second form of liability, if fraud were involved, the conduct would be actionable under section 10(b). *See, e.g.*, Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 160 (8th Cir. 1977); Zagari v. Dean Witter & Co., [1976-1977] FED. SEC. L. REP. (CCH) at 90,813-3.

[78] *See* text accompanying notes 58 and 59 *supra*.

[79] This was done through the promulgation of Regulation X, 549 F.2d at 170. *See also* note 9 *supra*.

[80] *See* Note and Comment, note 74 *supra*.

[81] [1976-1977] FED. SEC. L. REP. (CCH) at 90,813-3.

of an implied private right of action for violation of exchange and association rules has not totally been foreclosed by the acceptance of such in *Utah State University*.

CONCLUSION

The *Utah State University* decision reflects the Tenth Circuit's attempt to align itself more closely with the holdings of various recent Supreme Court securities decisions, while demonstrating a lack of understanding of the policy basis from which the Supreme Court opinions arose.[82] *Ernst & Ernst v. Hochfelder*, when viewed from the perspective of the Supreme Court decisions following it, appears to have been a logical step for the Court in light of its earlier decisions, *Blue Chip Stamps v. Manor Drug Stores* and *Cort v. Ash*.[83] The *Utah State University* decision reaches a result consistent with the recent position of the Supreme Court without exploring the analytical underpinnings so carefully laid by the Supreme Court as justification for its decisions. It is for that reason that although the decision is seemingly correct in the result it reaches, the Tenth Circuit's mode of analysis and the conclusions it draws therefrom are not totally consistent. In conclusion, the *Utah State University* decision represents the difficulties that the Tenth Circuit, like many other circuit courts, is having in reconciling the rather drastic reversal in the policy rationales being used by the Supreme Court in recent securities litigation and the broad, remedial, and flexible approach to the securities acts that for so long has been the touchstone of securities litigation in the federal courts.[84]

John L. Ruppert

---

[82] For a discussion of this recent reversal in the Supreme Court's attitude toward the federal securities laws, see, Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Ruppert, *The Supreme Court's Trimming of the Section 10(b) Tree: A New Securities Law Perspective*, 3 J. CORP. L. 112 (1977). For a graphic demonstration of the shift, see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975); Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

[83] *See* Lowenfels note 82 *supra*. *See also* Ruppert note 82 *supra*.

[84] See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (interpret the acts flexibly to effectuate their remedial purpose); Chris-Craft Indus. Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (protection of investors).