Cornell Law Review

Volume 51
Issue 4 *Summer 1966*

Article 1

Private Enforcement in the Over-the-Counter Securities Markets Implied Liabilities Based on NASD Rules

Lewis D. Lowenfels

CORNELL
LAW QUARTERLY

VOLUME 51 SUMMER 1966 NUMBER 4

PRIVATE ENFORCEMENT IN THE OVER-THE-COUNTER SECURITIES MARKETS: IMPLIED LIABILITIES BASED ON NASD RULES

Lewis D. Lowenfels†

The author focuses upon a new and intriguing theory of civil liability based upon Section 15A of the Securities Exchange Act of 1934. He suggests that a private action under the above section may be maintained by investors injured as a proximate result of violations of rules promulgated by the National Association of Securities Dealers, Inc. for the direct protection of the investing public. Such a private action is necessary, the author suggests, if the investing public is to be fully protected in dealings in the over-the-counter securities market.

INTRODUCTION

As originally enacted, the Securities Exchange Act of 1934[1] was designed primarily to regulate the trading of securities on national securities exchanges. Gradually, however, the original scope of the act was extended to apply with equal impact to the over-the-counter securities markets. First, the Maloney Act[2] was passed in 1938. This law, which was incorporated as section 15A[3] of the 1934 act, codified the concept of cooperative regulation of over-the-counter markets by government and industry. Regulation was accomplished by permitting qualified associations of broker-dealers to register with the Securities and Exchange Commission as "national securities associations." A registered association had to be appropriately organized, its rules had to be designed to meet certain standards and to achieve certain objectives, and it was required to discipline members who violated its rules.[4] The first, and to date the only, association to become registered pursuant to section 15A was

† Member of the New York Bar. A.B., Harvard University, 1957; LL.B., 1961. The author wishes to thank Michael S. Barron, Esq., David L. Marks, Esq., Leslie Susser, Esq. and Fern Lowenfels for their helpful suggestions in connection with the preparation of this article.

1 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-78jj (1964).

2 Securities Exchange Act § 15A, 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3 (1964).

3 Ibid.

4 Ibid.

the National Association of Securities Dealers, Inc. (NASD). Today, the membership of the NASD is nationwide. It includes virtually all broker-dealers engaged in a general securities business and represents wide diversities in financial resources, standards and activities.

The next major statutory development in the regulation of the over-the-counter securities markets was the enactment of the Investment Company Act in 1940.[5] Under this statute the activities of companies engaged primarily in the business of investing, reinvesting and trading in securities and whose own securities were held by the investing public, were subjected to statutory limitations and to SEC regulation in accordance with prescribed standards deemed necessary to protect the interests of investors and the public. Since the securities of most of these companies were traded exclusively in the over-the-counter markets, the regulatory impact was much greater in this area than with respect to securities exchanges.

The third step in this gradual statutory development was taken with the 1964 Securities Acts amendments.[6] Here, the reporting, proxy and insider trading provisions of the 1934 act, which formerly applied only to listed companies, were extended to apply to a large number of companies traded exclusively in the over-the-counter markets.

Concomitant with this development of increased regulation of the over-the-counter securities markets has been an expansion of implied liabilities and remedies pursuant to the 1934 act. In 1944 a private action against the New York Stock Exchange based on section 6 was sustained.[7] In 1946 implied liabilities were held to exist pursuant to the broad fraud provisions of section 10(b) of the act and rule 10b-5 promulgated thereunder.[8] Three years later an investor's right to bring a private action based on the margin requirements of section 7(c) was upheld.[9] During the same year a private action under the disclosure provisions of section 11(d)(2) was recognized,[10] and shortly thereafter a similar action based on the unlisted trading requirements of section 12(f) was sustained.[11] The climax came in 1964 when the Supreme Court recognized a private action based upon the proxy requirements of section 14 of the 1934 act.[12]

---

5 54 Stat. 789 (1940), as amended, 15 U.S.C. §§ 80a-1-52 (1964).
6 Securities Exchange Act, 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-78jj (1964).
7 Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
8 Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).
9 Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949).
10 Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949).
11 Standard Fruit & S.S. Co. v. Midwest Stock Exch., 178 F. Supp. 669 (N.D. Ill. 1959).
12 J. I. Case Co. v. Borak, 377 U.S. 426 (1964); see Chicago So. Shore & So. B.R.R. v. Monon R.R., CCH Fed. Sec. L. Rep. ¶ 91,525 (N.D. Ill. 1965), where a private action under § 16(a) was sustained.

This article is concerned with an action which would appear to be the logical extension or merger of the two trends described above—a private action pursuant to the rules of a securities association registered under section 15A of the 1934 act. The over-the-counter securities market, with its diffuseness and heterogeneity, its diversities in the character and standards of the companies traded as well as of the persons trading, would seem to be the ideal place to emphasize the concept of private enforcement. For the SEC, the NASD, or any state regulatory agency to attempt to control this sprawling, complex market without in the process creating a vast bureaucratic machine would be virtually impossible. If, however, the private investor is permitted to initiate a private action pursuant to section 15A, the entire investing public becomes the enforcement agency. Each individual investor, as a by-product of protecting his own interests and seeking his own private remedies, will serve as a discloser of, as well as a deterrent to, wrongdoing in these markets.

THE STATUTE

Any discussion as to whether or not a private action may be maintained based on the rules of a registered securities association must begin with an analysis of the relevant statutory provisions. The arguments in favor of permitting such an action may be set out as follows.

First, it appears clear that such an action would be consistent with the purpose of the act as stated in the preamble—"to prevent inequitable and unfair practices on [securities] . . . exchanges and [over-the-counter] markets . . . ."[13] Investors would be able to redress damages suffered, and brokers would be deterred from disregarding the standards of the act.

As a precondition to registration, section 15A(b)(8) requires a securities association to adopt rules, binding upon the membership, which are:

> [D]esigned to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market . . . .[14]

Thus the act, through the agency of the securities association, is imposing duties upon member firms for the benefit of the investing public. Pursuant to section 27, an action may be "brought to enforce any liability or duty created by this title or the rules and regulations thereunder."[15]

---

[13] Securities Exchange Act, 48 Stat. 881 (1934).

[14] Securities Exchange Act § 15A(b)(8), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(8) (1964).

[15] Securities Exchange Act § 27, 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1964).

Therefore, an action brought by a member of the investing public against a member firm to redress damages caused by violations of NASD rules, is an action to enforce a duty created by the statute within the meaning of section 27.

Section 15A(b) requires SEC approval of the rules of a securities association as a precondition to registration.[16] Section 15A(j) provides that before such rules may be changed, the proposed changes must be approved by the SEC.[17] Section 15A(k)(1) gives the SEC the power to abrogate association rules if "it appears to the Commission that such abrogation is necessary ... to assure fair dealing by the members of such association ... or otherwise to protect investors or effectuate the purposes of this title."[18] Section 15A(k)(2) empowers the Commission to alter or supplement the rules of a registered securities association in certain specified instances.[19] And experience shows that the SEC has not been loath to exercise its authority pursuant to these statutory provisions.[20] Where the SEC has such sweeping powers over association rules, these rules are virtually rules of the SEC itself, and should grant the same rights to investors as SEC rules grant. Since private actions may be maintained based on SEC rules, the same actions should be sustained based on NASD rules.

In 1952 the SEC "disapproved" a proposed NASD rule dealing with the trading activities of employees of member firms, pending determination as to whether the SEC would adopt its own rule in the same area.[21]

---

16 Securities Exchange Act § 15A(b), 52 Stat. 1071 (1938), as amended, 15 U.S.C. § 78o-3(b) (1964).

17 Securities Exchange Act § 15A(j), 52 Stat. 1074 (1938), as amended, 15 U.S.C. § 78o-3(j) (1964).

18 Securities Exchange Act § 15A(k)(1), 52 Stat. 1074 (1938), as amended, 15 U.S.C. § 78o-3(k)(1) (1964).

19 Securities Exchange Act § 15A(k)(2), 52 Stat. 1074 (1938), as amended, 15 U.S.C. § 78o-3(k)(2) (1964), provides:

(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to—

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof.

(B) the method for adoption of any change in or addition to the rules of the association.

(C) the method of choosing officers and directors.

(D) affiliation between registered securities associations.

20 National Ass'n of Sec. Dealers, Inc. 20 S.E.C. 508 (1945); National Ass'n of Sec. Dealers, Inc. 17 S.E.C. 459 (1944); National Ass'n of Sec. Dealers, Inc. 12 S.E.C. 322 (1942); National Ass'n of Sec. Dealers, Inc. 9 S.E.C. 38 (1941).

21 SEC Securities Exchange Act of 1934 Release No. 4723 (1952).

After a period had elapsed, during which the SEC's rule was submitted for public comment, the SEC determined to withdraw its proposal and allow the NASD rule to become effective.[22] "Thus," wrote the Commission, "the Association and its members take primary responsibility for the supervision of trading by employees of member firms, and the Commission is relieved of administering and enforcing another rule, with its attendant burdens and costs."[23] It would appear reasonable to conclude that the SEC determined that the NASD rule was sufficient regulation in this area. It is difficult to infer that the SEC would have withdrawn its own rule had it thought that the NASD rule would extend less protection to the investing public. Yet less protection is extended, if the SEC rule is held to engender private rights of enforcement while the NASD rule is held not to engender such rights.

Section 15A[24] is not specifically exempted from the antitrust laws. However, section 15A(i)(1) states:

> The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer . . . except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.[25]

And section 15A(n) provides:

> If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail.[26]

In effect, the statute is imposing economic sanctions upon persons excluded from membership in the NASD. And without the exemption provided by section 15A(n), these economic sanctions might very well be deemed to violate the antitrust laws. Where Congress feels that the policies underlying certain NASD rules are important enough to prevail over the policies underlying the antitrust laws, such rules would seem important enough to engender private rights and remedies in persons harmed by their violation.

Finally, under section 15(b)(10),[27] which was added to the act by the 1964 amendments, a broker-dealer who is not a member of a registered

---

22 SEC Securities Exchange Act of 1934 Release No. 4924 (1953).
23 Ibid.
24 Securities Exchange Act § 15A, 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3 (1964).
25 Securities Exchange Act § 15A(i)(1), 52 Stat. 1073 (1938), as amended, 15 U.S.C. § 78o-3(i)(1) (1964).
26 Securities Exchange Act § 15A(n), 52 Stat. 1075 (1938), as amended, 15 U.S.C. § 78o-3(n) (1964).
27 Securities Exchange Act § 15(b)(10), 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78o(b)(10) (1964).

securities association is regulated in his purchases and sales of over-the-counter securities by SEC rules authorized by identical statutory language and desigued to achieve identical statutory purposes as comparable NASD rules. However, since private actions are sustained under certain SEC rules, the broker-dealer who is not a member of the NASD may be subjected to private suits, while, for the same offense, his NASD counterpart may avoid granting redress to the investing public. While this anomalous situation may encourage increased membership in the NASD, it hardly seems consistent with the over-all scheme of statutory regulation.

The case against sustaining a private action, arguing only from the relevant statutory provisions, is less convincing. What is perhaps the most persuasive argument is based upon the language of sections 15A(b)(9)[28] and 15A(b)(10).[29] These sections of the act, which were amended by the Congress in 1964, deal in some detail with the disciplining of association members and their associates for violations of NASD rules. The statutory language specifically mentions "expulsion, suspension, fine, censure . . . or any other fitting penalty,"[30] but does not appear to contemplate a private action and remedy. The phrase "any other fitting penalty" juxtaposed to the words "expulsion, suspension, fine, censure"[31] and immediately preceding section 15A(b)(10), which requires the association to provide a fair and orderly *internal* judicial procedure to deal with violations of its rules,[32] is difficult to read as authorizing a private action in the federal courts. On the other hand, it may be contended that the scheme of discipline set out in sections 15A(b)(9) and 15A(b)(10) is not necessarily exclusive, and that, in any event, the phrase "any other fitting penalty" may be interpreted to grant investors a private action.

Another argument, which is not entirely unconvincing, is that Congress could never have intended to create a federal action under such sweeping language as conduct inconsistent with "just and equitable principles of trade."[33] Under the exclusive jurisdiction provided by section 27 of the act,[34] state courts would be ousted of jurisdiction over all actions

---

[28] Securities Exchange Act § 15A(b)(9), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(9) (1964).

[29] Securities Exchange Act § 15A(b)(10), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(10) (1964).

[30] Securities Exchange Act § 15A(b)(9), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(9) (1964).

[31] Ibid.

[32] Securities Exchange Act § 15A(b)(10), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(10) (1964).

[33] Securities Exchange Act § 15A(b)(8), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(8) (1964); see Colonial Realty Corp. v. Bache & Co., CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500 (S.D.N.Y. 1964), aff'd, CCH Fed. Sec. L. Rep. ¶ 91,644 (2d Cir. 1966).

[34] Securities Exchange Act § 27, 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1964).

in this area traditionally grounded solely upon state law.[35] Still, the language, though broad, *is* the direct creature of legislative fiat. And, if under section 15A(b)(4) a broker may be barred from a registered securities association for "conduct inconsistent with just and equitable principles of trade,"[36] it would not seem any more drastic to grant a private action to an investor for violations of this same standard.

Perhaps the most commonly used argument against implying liabilities and remedies contends that since sections 9(e),[37] 16(b)[38] and 18(a)[39] of the act grant express rights of action in certain circumstances, the maxim *"expressio unius est exclusio alterius"* denies any implied right of action under section 15A.[40] Moreover, the great majority of actions which have been judicially implied under the 1934 act have been based upon sections 7(c),[41] 10(b),[42] 14(a)[43] and 14(b)[44]—all of which include the language "it shall be unlawful." However, section 28(a) of the act states unequivocally that "the rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity,"[45] and the United States Supreme Court has for the most part taken a dim view of the *"expressio unius"* maxim. Indeed, in a leading securities case, the Court remarked that such maxims had long "been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text . . . to carry out . . . the generally expressed legislative policy."[46]

Finally, in section 15A(a)(2)[47] "rules of the association" is defined and appears to refer to rules different from those embraced within the phrase "this title and the rules and regulations thereunder" mentioned almost

---

[35] For a suggested solution to this problem based upon a burden of proof concept, see Colonial Realty Corp. v. Bache & Co., CCH Fed. Sec. L. Rep. ¶ 91,644 (2d Cir. 1966).

[36] Securities Exchange Act § 15A(b)(4)(A), 52 Stat. 1070 (1938), 15 U.S.C. § 78o-3(b)(4)(A) (1964).

[37] Securities Exchange Act § 9(e), 48 Stat. 889 (1934), 15 U.S.C. § 78(i)(e) (1964).

[38] Securities Exchange Act § 16(b), 48 Stat. 896 (1934), as amended, 15 U.S.C. § 78(p)(b) (1964).

[39] Securities Exchange Act § 18(a), 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r(a) (1964).

[40] Securities Exchange Act § 15A, 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3 (1964).

[41] Securities Exchange Act § 7(c), 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g(c) (1964).

[42] Securities Exchange Act § 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964).

[43] Securities Exchange Act § 14(a), 48 Stat. 895 (1934), 15 U.S.C. § 78n(a) (1964).

[44] Securities Exchange Act § 14(b), 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78n(b) (1964).

[45] Securities Exchange Act § 28(a), 48 Stat. 903 (1934), 15 U.S.C. § 78bb(a) (1964).

[46] SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943).

[47] Securities Exchange Act § 15A(a)(2), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(a)(2) (1964).

immediately following in section 15A(b)(1).[48] Since the latter phrase has an identical counterpart in section 27,[49] the argument may be made that "rules and regulations" as used in the jurisdictional section 27 do not include "rules of the association." The trouble with this argument is that jurisdiction for actions pursuant to association rules may be based upon that language in section 27 which authorizes actions "to enforce any . . . duty created by this title . . . ."[50] Moreover, the fact that Congress knew how to clearly distinguish the two sets of rules in section 15A may mean that it had no intention of making such a distinction in section 27.

The Legislative History

Once having analyzed the statutory language, it is appropriate to examine the legislative history to determine the congressional purpose with respect to a private action pursuant to the rules of a registered securities association. The Reports of both the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce, which deal with the background and purposes of section 15A of the act, are identical in emphasizing the vital importance of the over-the-counter markets, the abuses which had grown up, and the need for remedial measures.[51]

These Reports first analyze in some detail the reasons for enacting section 15A of the 1934 act. Almost seven thousand brokers and dealers are registered with the SEC as transacting business in the over-the-counter markets, nearly five times the total membership of the New York Stock Exchange. Approximately 60,000 separate issues of securities are traded over the counter, ten times the number of issues admitted to trading on all the stock exchanges in the country. "Moreover, the primary operations of the great underwriting houses take place over the counter."[52] Thus, not only a great variety of securities trade in the over-the-counter markets, but these markets also "provide the principal channel by which the savings of the nation flow into new financing."[53] The telephone, the telegraph and the mails link the various regional over-the-counter markets together in a vast interconnected network, national in scope and of "immense im-

---

[48] Securities Exchange Act § 15A(b)(1), 52 Stat. 1070 (1938), as amended, 15 U.S.C. § 78o-3(b)(1) (1964).

[49] Securities Exchange Act § 27, 48 Stat. 902, 903 (1934), as amended, 15 U.S.C. § 78aa (1964).

[50] Ibid.

[51] S. Rep. No. 1455, 75th Cong., 3d Sess. (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. (1938).

[52] S. Rep. No. 1455, 75th Cong., 3d Sess. 2 (1938); H.R. Rep. No. 2307, 75th Cong., 2d Sess. 3 (1938).

[53] Ibid.

portance to the national economy . . . ."[54] The conclusion is that the over-the-counter markets are themselves important enough to justify a reasonable system of regulation. Another compelling reason for regulation, however, was succinctly stated in the Senate Banking Committee Report accompanying the bill which became the 1934 act.[55] The Committee deemed it imperative to subject over-the-counter activities to the same regulations which are imposed upon stock exchange transactions. "This power is vitally necessary to forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on exchanges . . . to 'over-the-counter' markets . . . ."[56]

The Committee Reports then proceed to focus upon the abuses which had grown up in the over-the-counter markets. A small staff of SEC investigators was sent to Cleveland, Detroit and the Pacific Northwest to engage in surveys and review complaints. Within the space of a few months "13 individuals were criminally convicted, 16 more were placed under indictment, 17 corporations and 41 more individuals were enjoined, and 2 firms were expelled or obliged to withdraw from national securities exchanges, all for elementary violations of the law."[57]

Once having analyzed the reasons for enacting section 15A, the lawmakers describe in some detail the purposes which the legislation is designed to achieve. First is the desire to protect the investor and the honest broker from the unfair practices of the submarginal elements in the industry. Second is the necessity to cope with certain unethical methods of doing business which, while above the bare legal minimum, are "unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market . . . ."[58] And third is the intent to protect the investor and his savings and thereby protect the financial markets of the nation.

Two alternative methods of realizing these purposes are explored by the Committees, and a choice is made in favor of private enforcement.

> The committee believes that there are two alternative programs by which this problem could be met. The first would involve a pronounced expansion of the organization of the Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by

---

54 Ibid.
55 S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934).
56 Ibid.
57 S. Rep. No. 1455, 75th Cong., 3d Sess. 3 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4 (1938).
58 Ibid.
59 S. Rep. No. 1455, 75th Cong., 3d Sess. 3-4 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4-5 (1938).

> law. It might very well mean expanding the present process of registration of brokers and dealers with the Commission to include the proscription not only of the dishonest, but also of those unwilling or unable to conform to rigid standards of financial responsibility, professional conduct, and technical proficiency. The second of these alternative programs, which the committee believes distinctly preferable to the first, is embodied in S.3255. This program is based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation. In the concept of a really well organized and well-conducted stock exchange, under the supervision provided by the Securities Exchange Act of 1934, one may perceive something of the possibilities of such a program.[59]

This language is consistent with the remarks of Senator Maloney of Connecticut, the sponsor of section 15A, on the floor of the United States Senate immediately preceding the passage of his bill.

> The bill does not propose anything radical in the investment banking field. It does for that business about what was done for the exchanges through the Securities Exchange Act. It is not entirely a measure of self-regulation, but it very clearly provides an opportunity for self-regulation. Actually, it is cooperative regulation. Under this bill the Federal Government, through the Securities and Exchange Commission, says to the investment bankers of the country, "You may create your own association or associations. You may provide your own rules and your own regulations. We want you to run your own business. We want a representation, however. We want a right of review and supervision." So, while some of us would like to call what is provided for self-regulations it is in effect a cooperative regulation.[60]

This poses directly the question as to whether or not the legislators intended to authorize a private action pursuant to rules promulgated under section 15A as a necessary adjunct to private enforcement. A careful reading of the Senate and House Reports and the floor debates gives no indication one way or the other. It can be argued that since the private action is neither mentioned specifically in the statutory language nor in the legislative history, no such action was intended to be created. Moreover, the tenor of Senator Maloney's statements on the floor of the Senate is conservative and restricted. The bill is being passed with the blessing of the investment banking community, and no radical innovations are contemplated.[61]

The truth of the matter is probably that Congress never even considered the question of a private action pursuant to the rules of a registered securities association. A number of arguments, however, can be advanced to the effect that such a private action will assist in the realization of the congressional purposes as manifested in the legislative history.

---

[60] 83 Cong. Rec. 4451 (1938).
[61] Ibid.

First, the staff of the NASD could not possibly correct the abuses and realize the purposes as outlined by the legislators without becoming a mammouth bureaucracy. Too many issues are traded in the over-the-counter markets. Too many brokers are registered as doing business in these markets. The entire gamut of traders and the trading activity is much too diverse geographically. And such a mammoth bureaucracy is exactly what the legislators professed to avoid when they chose the method of private enforcement to effectuate the statutory purposes.[62] If, however, a private suit and private remedy based on NASD rules are permitted, then the entire investing public becomes the bureaucracy. Each individual member of this group becomes an overseer of the over-the-counter markets who, in protecting his own interest, will ferret out and bring to light violations and thereby act as a deterrent to wrongdoing. Second, the specific purposes as stated in the legislative history are furthered by the private suit. The submarginal elements in the industry will be less prone to mischief knowing that they may be subjected to a private action and to damages. The threat of the publicity of a trial in a highly competitive service business will help to deter unethical practices which barely exceed the legal minimum. And as suits are brought to recover damages resulting from these unethical practices, the courts may very well raise the standards of the duties imposed by this legal minimum on a case-by-case basis. Also, the private investor and his savings will be more secure with the legal instrument available to protect and recover his investments. Finally, the legislators sanctioned the creation of a registered securities association as an alternative to expanding the SEC.[63] Thus, presumably the NASD rules are a substitute for the promulgation of additional SEC rules. Since a private action may be maintained under certain of the latter rules, the same rights must be accorded the investing public under certain of the former rules. Otherwise, the public is receiving less protection pursuant to section 15A than it would receive under an expanded SEC, and this was certainly not the legislative purpose.

THE CASES

There is no lack of authority for implying liabilities pursuant to a federal statute.[64] As the United States Supreme Court declared in a leading decision:

> [W]here federally protected rights have been invaded, it has been the rule

[62] S. Rep. No. 1455, 75th Cong., 3d Sess. 3-4 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4-5 (1938).

[63] Ibid.

[64] Bell v. Hood, 327 U.S. 678 (1946); Tunstall v. Brotherhood of Locomotive Firemen & Enginemen, 323 U.S. 210 (1944); Fitzgerald v. Pan Am. World Airways, Inc., 229 F.2d 499 (2d Cir. 1956); Reitmeister v. Reitmeister, 162 F.2d 691 (2d Cir. 1947).

> from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief.[65]

The SEC statutes, in particular, have been quite fruitful in engendering private actions.[66] Indeed, the greatest flowering of these actions has been under certain provisions of the 1934 act itself.[67] An examination of the leading decisions dealing with implied liabilities under this statute may shed some light on the question of a private action based on section 15A.

The first important decision in this area was *Baird v. Franklin*,[68] decided by the Second Circuit in 1944. Here the court sustained an action by private investors against the New York Stock Exchange for its failure to discipline a member who had violated Exchange rules promulgated pursuant to section 6 of the act. Section 6 provides that the rules of a registered securities exchange must include "provision for the expulsion, suspension or disciplining of a member for conduct . . . inconsistent with just and equitable principles of trade . . . ."[69] In addition, exchange rules must be "just and adequate to insure fair dealing and to protect investors . . . ."[70]

The court in *Baird*, although holding that the complaint stated a cause of action, allowed no recovery, finding that the Exchange's dereliction of duties was not a proximate cause of plaintiffs' damages. There is no discussion in the court's opinion as to a possible action against parties other than the Exchange for violations of duties imposed by section 6. Judge Clark's concurring opinion, however, emphasized that if the primary purpose of the act—to completely and effectively protect the investing public—was to become a reality, then "§ 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges."[71] Judge Clark then declared:

> 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 injuries resulting from its breach and that the common law will supply a remedy if the statute gives none.[72]

While Judge Clark speaks specifically in terms of "duties imposed upon the exchanges," the policies relied upon to justify a private action against

---

[65] Bell v. Hood, supra note 64, at 684 (1946). [Footnote omitted.]
[66] Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961); Goldstein v. Groesbeck, 142 F.2d 422 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
[67] See text accompanying notes 68-90 infra.
[68] 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
[69] Securities Exchange Act § 6(b), 48 Stat. 886 (1934), 15 U.S.C. § 78f(b) (1964).
[70] Securities Exchange Act § 6(d), 48 Stat. 886 (1934), 15 U.S.C. § 78f(d) (1964).
[71] Baird v. Franklin, 141 F.2d 238, 245 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
[72] Ibid.

the Exchange for violations of duties prescribed by section 6 would seem equally applicable to justify private actions against parties other than the Exchange for violations of similar duties.[73] And once it is determined to sustain private actions against private persons based upon stock exchange rules, similar policies and logic would appear to support the same actions pursuant to NASD rules.

The next landmark decision in this area was *Kardon v. National Gypsum Co.*,[74] decided by Judge Kirkpatrick in the Eastern District of Pennsylvania in 1946. Here plaintiffs alleged that the defendants had induced them, by means of fraudulent misrepresentations, to sell certain securities to the defendants at substantial discounts in value. Plaintiffs sought damages, claiming that the defendants had violated section 10(b) of the act[75] and rule 10b-5[76] promulgated thereunder. Broadly stated, section 10(b) of the act and rule 10b-5 prohibit fraud, deceit, and material misrepresentations or omissions by any person in connection with the purchase or sale of a security. The court sustained plaintiff's action, following a line of reasoning similar to that employed in *Baird v. Franklin.* There was no question that defendants' conduct clearly violated section 10(b) and rule 10b-5. Nor was there any dispute that section 10(b) did not expressly allow civil suits by persons injured as a result of its violation.

> However, "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. . . ." Restatement, Torts, Vol. 2, Sec. 286. This rule is more than merely a canon of statutory interpretation. The disregard of the command of a statute is a wrongful act and a tort.[77]

The court swept aside the "*expressio unius est exclusio alterius*" argument based upon the express provisions for a civil action contained in sections 9(e), 16(b) and 18(a) of the act. The whole question was not one of statutory interpretation, but "whether an intention can be implied to deny a remedy and to wipe out a liability which, normally, by virtue of basic principles of tort law accompanies the doing of the prohibited act."[78] The court emphasized that where one vital purpose of the act was to eliminate manipulative and deceptive methods by regulation, the defendants' con-

---

[73] See Colonial Realty Corp. v. Bache & Co., CCH Fed. Sec. L. Rep. ¶ 91,644 (2d Cir. 1966); Lowenfels, "Implied Liabilities Based Upon Stock Exchange Rules," 66 Colum. L. Rev. 12 (1966).

[74] 69 F. Supp. 512 (E.D. Pa. 1946).

[75] Securities Exchange Act § 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1964).

[76] 17 C.F.R. § 240.10b-5 (1964).

[77] Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

[78] Id. at 514.

tentions that no private action could be sustained pursuant to section 10(b) and rule 10b-5 must not prevail. Today, it is settled in virtually every circuit that an implied private remedy may be granted for damages resulting from the violation of section 10(b) and rule 10b-5.[79]

The development of the doctrine of implied liabilities under the 1934 act was further extended in 1948 by the decision of the Federal District Court in Massachusetts in *Remar v. Clayton Sec. Corp.*[80] Relying upon *Baird v. Franklin* and *Kardon v. National Gypsum Co.*, Judge Wyzanski held, that where a broker had arranged excessive bank credit for a customer in violation of Federal Reserve Board regulations, the customer could maintain a private action against the broker pursuant to section 7(c)[81] of the act for damages suffered as a proximate consequence of the violation. Section 7(c) makes it unlawful for certain brokers, directly or indirectly, to extend or maintain, or arrange for the extension or maintenance of, credit to any customer with respect to a registered security in contravention of rules promulgated by the Federal Reserve Board. The court's reasoning had a familiar ring:

> The Securities and [sic] Exchange Act does not expressly give a right or remedy to a private person injured by § 7(c) of that Act. But such a right may nonetheless be implied. . . . The general principle regarding civil liability for violations of prohibitory statutes . . . . is that where defendant's violation of a prohibitory statute has caused injury to plaintiff the latter has a right of action if one of the purposes of the enactment was to protect individual interests like the plaintiff's.[82]

These holdings by federal district and appellate courts were climaxed in 1964 by the Supreme Court's decision in *J. I. Case Co. v. Borak.*[83] Here a stockholder initiated a civil action in federal court claiming deprivation of his preemptive rights by reason of a merger effected through the use of a false and misleading proxy statement. Plaintiff alleged a violation of section 14(a) of the 1934 act with reference to the proxy solicitation material and asserted federal jurisdiction based upon section 27. Section

---

[79] Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Estate Counseling Serv. Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962). In addition, dictum in other circuits and acceptance by federal district courts indicates approval of the doctrine of implied civil liability pursuant to Rule 10b-5. See, e.g., Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963); Nash v. J. Arthur Warner & Co., 137 F. Supp. 615 (D. Mass. 1955); Beury v. Beury, 127 F. Supp. 786 (S.D.W. Va. 1954), appeal dismissed, 222 F.2d 464 (4th Cir. 1955).

[80] 81 F. Supp. 1014 (D. Mass. 1949).

[81] Securities Exchange Act § 7(c), 48 Stat. 886 (1934), as amended, 15 U.S.C. § 78g(c) (1964).

[82] Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949).

[83] 377 U.S. 426 (1964).

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."[84] SEC Rule 14a-9 prohibits proxy solicitations which contain any false or misleading statements or any material omissions.[85] Section 27 grants the federal district courts jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created" under the act.[86]

The Supreme Court sustained plaintiff's federal cause of action. "It appears clear," declared the Court, "that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Act."[87] The latter section was desigued to prevent management or other persons from obtaining authorization for corporate action by means of misleading proxy materials. While the language of section 14(a) makes no specific reference to a private action, the plırase "the protection of investors" clearly implies the "availability of judicial relief where necessary to achieve that result."[88] The Court quoted its own decision in *Deckert v. Independent Shares Corp.*:[89]

> The power to *enforce* 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.[90]

The first and only case to deal directly with the issue of a private action based on NASD rules was *Colonial Realty Corp. v. Bache & Co.*[91] The opinion of Judge Croake in the district court, however, abruptly reversed what had appeared to be the dominant trend. Judge Croake held unequivocally that a customer suing his broker for damages resulting from conduct allegedly inconsistent with just and equitable principles of trade within the meaning of section 15A(b)(8) of the 1934 act did not state a federal claim. Plaintiff's argument had relied primarily upon the authority of *Bell v. Hood* and *Baird v. Franklin*. It contended that the actions complained of—selling securities in a margin account in violation of a written agreement not to do so unless the equity owned fell below prevailing

---

84 Securities Exchange Act § 14(a), 48 Stat. 895 (1934), 15 U.S.C. § 78n(a) (1964).
85 17 C.F.R. § 240.14a-9 (1964).
86 Securities Exchange Act § 27, 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1964).
87 J. I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964).
88 Id. at 432.
89 311 U.S. 282 (1940).
90 J. I. Case Co. v. Borak, supra note 87, at 433-34. For private actions under other sections of the 1934 act, see Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949) (§ 11(d)(2)); Standard Fruit & S.S. Co. v. Midwest Stock Exch., 178 F. Supp. 669 (N.D. Ill. 1959) (§ 12(f)).
91 CCH Fed. Sec. L. Rep. ¶ 91,351 (S.D.N.Y. 1964), aff'd, CCH Fed. Sec. L. Rep. ¶ 91,644 (2d Cir. 1966).

margin requirements—justified a federal, civil remedy, since federal law had been violated and a member of the class which such law sought to protect had been injured. More specifically, plaintiff alleged that as a member of the NASD defendant was subject to its rules; and since these rules had been promulgated pursuant to section 15A, allegations of their breach stated causes of action under section 27. The court disagreed, finding that the violations attributed to defendants justified claims grounded upon state law, but not upon a federal statute. The court made a number of statements that must be examined with care. First, the court wrote:

> Section . . . 15A of the [1934] Act . . . do[es] not explicitly impose duties upon brokers, but rather require[s] . . . national securities associations registered under the Act . . . to promulgate rules requiring their members to abide by "fair and equitable principles of trade."[92]

This statement appears to be self-contradictory. If national securities associations are required by the 1934 act to promulgate rules requiring member firms to adhere to certain standards of conduct, it would seem that this statute is imposing duties upon these member firms. Indeed, the 1934 act imposes standards in many areas—fraud, disclosure, credit, maintenance of records, to name but a few—and these standards embodied in NASD rules are duties created by the 1934 act. Since such standards are embodied in NASD rules primarily to guide the conduct of member firms in their relations with the investing public, it seems erroneous not to conclude that section 15A imposes duties running from the member firms to the investing public.

The court also stated:

> Furthermore, the rules of the . . . NASD, which defendant is alleged to have violated, were not intended to be included within the phrase "rules and regulations" contained in Section 27. It is obvious that that phrase applies only to rules and regulations promulgated by the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System. Section 23(a) of the Act grants those two agencies power to promulgate "rules and regulations" whereas Section . . . 15A speak[s] in terms of "rules" of an . . . association as distinct from "rules and regulations" promulgated by the Commission.[93]

Why is it so obvious that section 27 differentiates between rules of the NASD and rules of the SEC and the Federal Reserve Board? We have already noted that the legislators knew how to make such a distinction clear in sections 15A(a)(2) and 15A(b)(1).[94] The fact that section 27 makes no such distinction may just as easily be read to support an in-

[92] Colonial Realty Corp. v. Bache & Co., CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500 (S.D.N.Y. 1964).
[93] Ibid. [Footnote omitted.]
[94] See text accompanying notes 47-48 supra.

terpretation opposed to that of the court. More important, however, is the language in section 27 that the federal district courts shall have jurisdiction of suits "brought to enforce any liability or duty created by this title or the rules and regulations thereunder."[95] The court did not mention this portion of section 27. *Baird v. Franklin* was distinguished on the grounds that the liability of the New York Stock Exchange in that decision "was predicated upon the duty of supervision of its members directly imposed upon it by Section 6(b), whereas in the instant case liability is asserted as to a [person] ... upon whom no direct duty is imposed by the Act."[96] Judge Croake went on to articulate the policies underlying his decision, arguing that Congress could never have intended to give federal claims carrying exclusive jurisdiction in federal courts to customers against brokers for violations of such a sweeping standard as "just and equitable principles of trade." The doctrine of *Bell v. Hood* was "not without limitation."[97] The claims of plaintiff were grounded primarily upon state law; plaintiff's federal allegations were "merely reiterations of the common law claims."[98]

On March 10, 1966, the district court's judgment in *Colonial Realty Corp. v. Bache & Co.* was affirmed by the United States Court of Appeals for the Second Circuit.[99] Judge Friendly's opinion, however, virtually reversed Judge Croake's holding. After summarizing the arguments for both sides, the court wrote:

> 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.[100]

The court went on to state that the particular rules at issue, which imposed duties upon member firms not to engage in conduct inconsistent

---

[95] Securities Exchange Act § 27, 48 Stat. 902-03 (1934), as amended, 15 U.S.C. § 78aa (1964).

[96] Colonial Realty Corp. v. Bache & Co., CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500 (S.D.N.Y. 1964).

[97] Ibid. To support this proposition the Court cited Howard v. Furst, 140 F. Supp. 507 (S.D.N.Y. 1956), aff'd, 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957), which had been uniformly criticized by the commentators, see 2 Loss, Securities Regulation 949-52 (1961), and was recently overruled; see Studebaker Corp. v. Gittlin, CCH Fed. Sec. L. Rep. ¶ 91,657 (2d Cir. 1966).

[98] Colonial Realty Corp. v. Brache & Co., CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500 (S.D.N.Y. 1964).

[99] CCH Fed. Sec. L. Rep. ¶ 91,644 (2d Cir. 1966).

[100] Id. at 95,402.

with fair and equitable principles of trade, were something of a "catch-all," which imposed ethical as well as legal standards. "We find little reason to believe," concluded the court, "that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law."[101] Judge Friendly was particularly wary of saddling the federal courts with garden-variety customer-broker suits where no traditional basis for federal jurisdiction existed. The court appears to have left this problem to be resolved in the future on a case-by-case basis depending upon burden of proof, with the burden being the lightest where the rule at issue imposes a specific duty unknown to the common law.

In effect, the Second Circuit held, that while plaintiff in the case at bar had not satisfied the heavy burden of proof required to establish a federal claim under certain association rules, such a claim might be recognized in the future based upon other association rules depending upon "the nature of the particular rule and its place in the regulatory scheme . . . ."[102]

A Suggested Analysis

When the standard set out by the Court of Appeals in *Colonial Realty* is applied to the specific scheme of NASD regnlation, the most fruitful approach appears to be to sustain private actions based upon certain NASD rules and not to sustain such actions based upon other NASD rules. In other words, the NASD rules which are promulgated for the direct protection of the investing public should engender private actions, while the NASD rules which are promulgated merely as "housekeeping" devices to regulate the technicalities of the members' day-to-day business activities should not engender such actions. With respect to those rules promulgated for the direct protection of the investing public, the case for an implied private action should be strongest when the rule at issue imposes an explicit duty unknown to the common law. The logic and policy supporting such a distinction seem valid. Under one set of rules the investing public is really a third party beneficiary of duties imposed upon the member firms and as such is entitled to enforce its rights. Under the other set of rules the investing public has no such status and no comparable interests which justify protection in the courts.

If the above reasoning is applied to presently existing NASD rules, there is a very logical dichotomy between the Rules of Fair Practice, which should engender private actions, and the Uniform Practice Code,

101 Ibid.
102 Ibid.

which should not engender such actions. The purposes of the Rules of Fair Practice are described in the NASD's Bylaws:

> To promote and enforce just and equitable principles of trade and business, to maintain high standards of commercial honor and integrity among members . . . to prevent fraudulent and manipulative acts and practices, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, to protect investors and the public interest, to collaborate with governmental and other agencies in the promotion of fair practices and the elimination of fraud, and in general to carry out the purposes of . . . Section 15A of the Act . . . .[103]

This language is a paraphrase of section 15A(b)(8) of the 1934 act and is concerned primarily with protecting the interests of the investing public.

The rules themselves cover many facets of the relationship between the member firm and the public. Among the more important rules are those which prohibit the most flagrant abuses of the selling relationship. Sales by misrepresentations are prohibited by language similar to the anti-fraud provisions of the federal securities laws.[104] Excessive trading in discretionary accounts is banned by a rule which, with respect to such an account, prohibits "any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account."[105] This rule specifically relates only to those accounts where the member is vested with discretionary power. Recommendations by salesmen which lead to excessive trading as well as to purchases which are inappropriate to the particular investor's circumstances run afoul of the NASD's "suitability" rule which provides:

> 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.[106]

The member's responsibility to oversee his salesmen's activities is enunciated as follows:

> A member who employs any registered representative shall supervise all his transactions and all correspondence relating thereto. All transactions made by a registered representative with or for a customer shall be approved by a partner, a duly accredited executive, or a branch office manager of such member. . . .[107]

Other NASD Rules of Fair Practice govern certain disclosure aspects of selling practices, such as the rules requiring every member to inform his

---

[103] Art. VII, § 1, NASD Manual C-39.
[104] NASD Rules of Fair Practice Art. III, § 18, NASD Manual D-10.
[105] NASD Rules of Fair Practice Art. III, § 15(a), NASD Manual D-8.
[106] NASD Rules of Fair Practice Art. III, § 2, NASD Manual D-5.
[107] NASD Rules of Fair Practice Art. III, § 27(a), NASD Manual D-18.

customers whether he is acting as a broker or dealer at or before the completion of each transaction,[108] whether he is in a control relationship with the issuer of the security which he is trading,[109] or whether he has an interest in a primary or secondary distribution of securities which he is selling.[110]

There are still further rules which focus upon additional problems arising out of the relationship between member firms and the investing public. Charges to customers for services performed must be "reasonable and not unfairly discriminatory between customers."[111] A member acting for his own account in transactions with customers must buy and sell at prices which are "fair, taking into consideration all relevant circumstances . . . ."[112] No member may extend an offer to buy or sell unless he is prepared to act upon his offer as extended.[113] Funds and securities of customers must be properly maintained and safeguarded.[114] And no member may give anything of value to any person for the purpose of circulating material which will affect the market price of a security.[115]

The purposes of the Uniform Practice Code as described in the NASD's Bylaws are substantially different from the purposes of the Rules of Fair Practice.

> [T]o make uniform, where practicable, custom, practice, usage, and trading technique in the investment banking and securities business with respect to such matters as trade terms, deliveries, payments, dividends, rights, interest, reclamations, exchange of confirmations, stamp taxes, claims, assignments, powers of substitution, computation of interest and basis prices, due-bills, transfer fees, "when, as and if issued" trading, "when, as and is distributed" trading, marking to the market and close-out procedure, all to the end that the transaction of day-to-day business by members, may be simplified and facilitated, that business disputes and misunderstandings, which arise from uncertainty and lack of uniformity in such matters, may be eliminated . . . .[116]

The primary purpose of the Code is to regulate the day-to-day mechanics of business dealings among member firms. The Code itself is a compendium of technical regulations having comparatively little direct impact upon the investing public. Many intricate technical problems are covered, such as when transactions in bonds which are traded "flat" shall be "ex-interest,"[117] how the settlement price of contracts in "part-redeemed"

---

108 NASD Rules of Fair Practice Art. III, § 12, NASD Manual D-8.
109 NASD Rules of Fair Practice Art. III, § 13, NASD Manual D-8.
110 NASD Rules of Fair Practice Art. III, § 14, NASD Manual D-8.
111 NASD Rules of Fair Practice Art. III, § 3, NASD Manual D-5.
112 NASD Rules of Fair Practice Art. III, § 4, NASD Manual D-6.
113 NASD Rules of Fair Practice Art. III, § 6, NASD Manual D-6.
114 NASD Rules of Fair Practice Art. III, § 19(a), NASD Manual D-10.
115 NASD Rules of Fair Practice Art. III, § 11, NASD Manual D-7.
116 Art. XIV, § 1, NASD Manual C-49.
117 NASD Uniform Practice Code § 6(a), NASD Manual F-4.

bonds shall be determined,[118] how a confirmation covering a transaction in a security "when, as and if issued" shall identify the security,[119] and how the assignment and each power of substitution pertaining to a certificate of a company whose transfer books are closed indefinitely shall be acknowledged.[120] Without going into an extensive compilation, it seems clear that the Uniform Practice Code does not include the kinds of rules that should engender private rights in members of the investing public. These rules do not satisfy the crucial test for implied liabilities pursuant to NASD rules—that the rule in question be designed for the direct protection of the investing public. Moreover, it would appear that a violation of the rules contained in the Code will seldom, if ever, be a proximate cause of injury to a member of the public.

Once admitting that there are certain NASD rules which justify implying liabilities, the next problem is to assess the practical impact of this admission upon the individual investor. First and foremost, the private action based on NASD rules will give this investor a federal remedy which never before existed. Under present practice the investor who is harmed by a member firm's violation of NASD rules files a written complaint with one of the NASD's District Business Conduct Committees.[121] A copy of these allegations is forwarded to the member firm and the latter is given an opportunity to file a written reply.[122] Either party, or the Committee itself, may request a hearing.[123] After due deliberations, the District Committee is empowered to render a decision and affix a penalty.[124] These decisions may be appealed to the NASD's Board of Governors[125] and ultimately to the SEC.[126] While at first glance this procedure appears adequate to protect the public investor, there is one crucial omission. All of the permissible penalties—censure, fine, suspension, expulsion, revocation—while sufficient to punish the member firm, make no provision for awarding damages to the aggrieved investor.[127] It is not surprising, therefore, that there have been a very limited number of public complaints for violations of NASD rules.[128] As the recent *Report of Special Study of Securities Markets of the Securities and Exchange Commission* has emphasized:

118 NASD Uniform Practice Code § 8, NASD Manual F-5.
119 NASD Uniform Practice Code § 11, NASD Manual F-5, -6.
120 NASD Uniform Practice Code § 31, NASD Manual F-12.
121 NASD Code of Procedure § 4, NASD Manual E-2.
122 NASD Code of Procedure § 6, NASD Manual E-2.
123 NASD Code of Procedure § 8, NASD Manual E-3.
124 NASD Code of Procedure § 11, NASD Manual E-4.
125 NASD Code of Procedure § 14(a), NASD Manual E-7.
126 NASD Code of Procedure § 19, NASD Manual E-10.
127 NASD Rules of Fair Practice Art. V, § 1, NASD Manual D-25.
128 H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 663 (1963).
129 H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 664 (1963).

> [A]lthough NASD staff and committee officials may offer a degree of assistance in the preparation of formal complaints and prosecution of the case, the responsibility for proceeding and carrying the case forward lies largely with the public complainant. Many potential complainants are unquestionably discouraged from going forward by the burdens involved in assuming that role, especially since this procedure will not result in restitution or other benefit to the complainant.[129]

A private action based on NASD rules will broaden the substantive scope of investor protection. While certain NASD rules have their counterparts in common law claims, or in SEC regulations pursuant to which a private action may be sustained, such vital NASD rules as the suitability and supervisory rules quoted above have no common law or SEC counterparts. Moreover, the substantial advantages with respect to service of process and venue accruing to plaintiffs basing their actions on the 1934 act are not applicable to common law claimants.[130]

CONCLUSION

The regulation of the over-the-counter securities markets has become an issue of paramount importance in recent years. The vast number of companies whose securities are traded in these markets together with their inherent geographical diversity have made the regulatory task considerably more difficult in this area than with respect to the stock exchanges. This is clearly illustrated by the numerous examples of abuses described in the *Report of Special Study of Securities Markets of the Securities and Exchange Commission*.[131] The solution, unfortunately, is not simple. To create a vast governmental bureaucracy to oversee the over-the-counter markets would be anathema to our traditions as well as contradictory to the declared legislative purpose. Delegating the entire regulatory responsibility to the NASD has proven to be less than completely satisfactory.[132] Perhaps the answer lies in an expanded concept of private enforcement spearheaded by private actions by investors pursuant to the rules of the NASD.

The development of the law in this area of implied liabilities and remedies pursuant to the federal securities acts has undergone tremendous growth and expansion in recent years. Many courts have recognized that such growth is vital if the securities acts are to accomplish their avowed purpose of fully protecting the investing public. The NASD's charter has the following stated objects and purposes:

---

130 See Lowenfels, "Rule 10b-5 and the Stockholder's Derivative Action," 18 Vand. L. Rev. 893 (1965).
131 H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 268-330, 487-560 (1963).
132 H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 646-82 (1963).
133 Art. III, NASD Manual C-1.

> (1) . . . to promote . . . high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws;
>
> (2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;
>
> (3) To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;
>
> (4) To . . . adjust grievances between the public and members . . . ;
>
> (5) To establish, and to register with the Securities and Exchange Commission as, a national securities association pursuant to Section 15A of the Securities Exchange Act of 1934, as amended, and thereby to provide a medium for effectuating the purposes of said section . . . .[133]

To sustain private actions pursuant to NASD Rules of Fair Practice would be consistent with these purposes as well as with the fundamental policies underlying the federal securities laws.