Civil Liability Under the Credit-Regulation Provisions of the Securities Exchange Act of 1934

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INTRODUCTION

The precipitous expansion of "federal corporation law" has resulted largely from judicial willingness to imply civil remedies under the federal securities acts. In particular, courts have focused

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their creative energies on several provisions of the Securities Exchange Act of 1934 (Exchange Act).\(^2\) With private suits under sections 10(b)\(^3\) and 14(a)\(^4\) commanding a dominant share of the legal commentary, the case law's widespread recognition of civil lender liability under the Exchange Act's credit-regulation provisions—section 7\(^5\) and the implementing Federal Reserve regulations\(^6\)—has attracted scant attention. The creation of substantive rights in the security-credit area implicates broad macroeconomic policy goals. Thus, a number of unique and important issues arise—issues that courts need not confront when implying rights under the antifraud or disclosure-oriented provisions of the securities laws.

In the thirty years since courts began awarding civil relief to aggrieved margin investors,\(^7\) a large body of precedent has developed, displaying inconsistencies in both the rationale enunciated for implying a remedy and the scope of the remedy granted. Two recent developments complicate matters further. In 1970, Congress added section 7(f) to the Exchange Act,\(^8\) for the first time making it unlawful for an investor to obtain credit in violation of the margin regulations applicable to lenders. More recently, the Supreme Court has articulated a rationale for implying private rights of action that cuts back substantially the broad mandate of prior case law.\(^9\) Although these developments unquestionably restrict the basis for recognizing comprehensive civil lender liability under section 7, their ultimate impact is uncertain; indeed, conflicts in their interpretation have exacerbated fundamental incon-

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\(^6\) Regulation T, 12 C.F.R. §§ 220.1-.8 (1977); Regulation U, id. §§ 221.1-.4; Regulation G, id. §§ 207.1-.5; Regulation X, id. §§ 224.1-.6.

\(^7\) The first decision to recognize the availability of civil relief under § 7 was Appel v. Levine, 85 F. Supp. 240 (S.D.N.Y. 1948).


sistencies in the case law. A general survey of the history and current status of private actions under the security-credit regulations will provide a basis for developing the policy questions underlying section 7 liability.

I

BACKGROUND

A. Rationales for Margin Regulation

In the typical security-credit transaction, an investor obtains a loan from a broker, bank, or other lender to finance a purchase of securities. The loan agreement requires that the investor pledge the purchased securities as collateral, and permits the lender to sell them at the lender's discretion. The lender advances only a portion of the purchase price; the investor provides the remainder in cash. In the absence of regulation, the lender looks to the borrower's creditworthiness and the nature of the pledged securities to determine how large a loan it can safely make. Generally, the loan is repayable on demand. The investor's cash contribution to the purchase price of the securities is his initial equity; the ratio of his initial equity to the purchase price determines the "initial margin" percentage. The investor's equity fluctuates to reflect changes in the market value of the collateral. A lender normally demands more collateral as the investor's equity diminishes. If the investor fails to meet the "margin call," the lender sells the pledged securities to satisfy the loan. Often, a lender's house rules require that the lender make a margin call whenever the ratio of the investor's equity to the market value of the collateral falls below a predetermined level. This level—the required "maintenance margin" percentage—is set lower than, but relatively close to, the initial margin percentage that the lender would impose in the absence of regulation.

10 At any point in time, the investor's equity is the difference between the market value of his pledged securities and the loan balance outstanding.

11 Thus, an investor borrowing $6,000 for the purchase of securities worth $10,000 has an initial equity of $4,000, representing an initial margin of 40%. If the market value of the securities falls to $8,000 before the investor has repaid any part of the loan, his equity correspondingly falls to $2,000. If the lender's house rules require a maintenance margin of 20%, the lender will make a margin call if the market value of the securities drops to $7,500.

Although this terminology can be used to describe any lending arrangement in which securities (or any other easily-valued assets) serve as collateral, it is usually employed to refer specifically to broker-customer dealings.
Section 7 of the Exchange Act and the regulations implementing that provision interfere with the market forces that would otherwise determine the behavior of participants in security-credit transactions. It is essential to examine the possible motives behind this regulatory incursion, since the recognition of implied private rights of action depends in part on the legislative intent underlying section 7.

Costs necessarily accompany any regulatory scheme; regulation should be imposed only if the benefits to be derived justify the associated costs. In the field of security credit, experience demonstrates that the regulatory costs are high. The margin rules, technical and complex to begin with, show a tendency to grow even more complex as regulators seek to frustrate lenders' and investors' attempts at evasion. Any claimed benefits of margin regulation, then, must be weighed against significant economic burdens of administration, enforcement, and compliance.

In determining the appropriate form and scope of margin regulation, it is helpful to view the broad field of security credit as encompassing two types of loans: loans taken for the purpose of purchasing or carrying securities, regardless of whether they are collateralized by securities (purpose loans); and loans collateralized by securities, regardless of their purpose (security-collateralized loans).\(^{12}\) Within this framework, a three-step analysis should be applied to each justification advanced for margin regulation. First, does the offered justification require limiting regulation to the area of security credit? If so, does the justification mandate regulation extending to all security credit, to purpose loans only, to security-collateralized loans only, to loans falling into both categories,\(^{13}\) or to some different subclass of security credit? Finally, do administrative considerations require altering the regulatory scheme that would otherwise best serve the asserted goal? These questions are helpful in judging both the theoretical soundness of a particular justification for margin control, and the likelihood that the justification actually motivated Congress to adopt margin regulation in its present form.

Three basic justifications have been advanced for security-credit regulation.

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\(^{12}\) See J. Bogen & H. Krooss, Security Credit 12 (1960) [hereinafter cited as Bogen & Krooss]. The term “security credit” may also include loans made to underwriters to finance their initial distributions of securities. See id. at 20-21. Such loans are not a concern of this Article.

\(^{13}\) The security-credit transaction outlined in the text accompanying notes 10-11 supra exemplifies loans that fall into both categories.
1. **Protection of Borrowers**

Many observers contend that the securities investor needs special protection when he deals on margin.\(^1\) They argue that without protection, the investor will fall victim to his imprudence and ignorance regarding the volatility of securities prices, and may overextend himself financially. Presumably, this argument supports regulation of all security-collateralized loans (and, for that matter, all loans that the investor obtains in reliance on the financial safety-cushion of his securities assets). This borrower-protection rationale for margin control necessarily considers market forces (such as the concern of lenders for the safety of their loans) inadequate to prevent borrowers from assuming excessive liabilities. Here, the rationale faces perhaps its strongest analytical and empirical challenges.\(^2\)

2. **Protection of the Financial Community**

Lenders compete fiercely to provide loans collateralized by securities. Brokers, drawn by the prospect of commissions on new accounts, are particularly apt to offer generous credit arrangements to attract customers. Some argue, therefore, that margin regulation is necessary to preserve lenders' solvency because highly desirable security-collateralized loans provoke destructive competition among lenders.\(^3\) This argument seems especially persuasive in light of the peculiar confidence-related "domino" effects that accompany institutional failures in the financial community.

3. **Furtherance of National Economic Policies**

Advocates of security-credit regulation often look beyond the welfare of individual market participants to the general economic health of the nation. This macroeconomic orientation characterizes three otherwise distinct rationales for margin control, each of which merits individual examination.

a. **Maintenance of funds for "productive" uses.** Some argue that the maintenance of high levels of purpose credit reduces the

\(^{1}\) Indeed, it appears that investor-protection was the primary objective of many of the pre-Exchange Act proposals for security-credit regulation. Bogen & Krooss, supra note 12, at 75.


amount of funds available for more productive economic sectors. The validity of this assertion is doubtful. Purpose credit merely facilitates transfers of securities. It does not represent a claim on real resources. If margin restrictions were eliminated, sellers of securities would simply replace margin purchasers as ultimate consumers, leaving the aggregate amount of funds available for consumption unchanged. Purpose credit channels funds away from business uses only when creditors curtail their business lending to make purpose loans. It is questionable, however, whether lenders ever take such action. It is also questionable whether loans to businesses are more “productive” than security loans in any sense that justifies selective governmental intrusion into the credit markets.

b. Control of monetary aggregates. It is widely theorized that levels of purpose credit do not necessarily respond to the conventional techniques of national credit management exercised by the Federal Reserve Board (FRB). According to this theory, even high interest rates do not deter investors from seeking maximum leverage in a highly optimistic market. Conversely, when market forecasts are strongly negative, lowered interest rates fail to stimulate investors’ credit demands. Indeed, margin investors may even sell out their positions and liquidate security loans at such times. Margin lending may therefore interfere with the FRB’s pursuit of an orderly monetary policy. Security-credit control has been urged as a selective, “qualitative” addition to the FRB’s “quantitative” credit control, or, in the words of one FRB Chairman, as “a supplementary instrument of credit policy—one of the means of making a broad credit and monetary policy effective.”

c. Reduction of securities-market volatility. A report of the Senate Committee on Banking and Currency summarizes the traditional view of the relationship between security credit and market fluctuations:

18 See Bogen & Krooss, supra note 12, at 38-40; Moore, supra note 15, at 160.
19 See Bogen & Krooss, supra note 12, at 40.
20 See id. at 41; Moore, supra note 15, at 160.
21 See Bogen & Krooss, supra note 12, at 46-49.
22 See id. at 30-32, 47.
23 See id. at 49.
Experience has shown that too much credit may operate to inflate stock prices far beyond underlying values, with harmful effects upon the economy generally. The excessive use of credit for buying and carrying securities accentuates market downswings. Those who hold stocks which are financed by credit may be forced by the lender to sell in order to protect the loan. This can lead to additional selling and as stock prices go even lower, others with stocks financed by credit may be forced to unload. At its worst, this type of chain reaction contains the danger of making a market break more serious and disorderly.\textsuperscript{25}

The ability of margin investors to "pyramid" their holdings may be largely responsible for chain reactions of this sort. "Pyramiding" refers to a cyclical phenomenon: as securities prices rise, holders' credit capacities increase; holders use this excess capacity to finance the purchase of additional securities,\textsuperscript{26} pushing prices higher and thus increasing borrowing capacities still further. Although pyramiding may theoretically occur in conjunction with nonsecurity lending, it takes place, as a practical matter, only in the security-credit area. The liquidity of securities allows speedy ascertainment of their increased market value; thus, upward adjustments in loan balances may be effected promptly.\textsuperscript{27} It follows that, in the absence of margin regulation, investors' equity in their pyramided holdings never rises far above the maintenance margin levels required by lenders. Even a relatively small downswing in the market, then, brings speedy margin calls, followed by further margin calls as forced selling\textsuperscript{28} amplifies initial price declines.\textsuperscript{29} In short, margin


\textsuperscript{26} At least one commentator, however, has questioned the validity of the assumption that excess borrowing capacity will be used for additional purpose loans. See Moore, supra note 15, at 164-66.

\textsuperscript{27} See Bogen & Krooss, supra note 12, at 49; Special Study, supra note 16, at 9.

\textsuperscript{28} See Special Study, supra note 16, at 9-11; Solomon & Hart, Recent Developments in the Regulation of Securities Credit, 20 J. Pub. L. 167, 169 (1971). Margin calls lead to forced selling only if borrowers lack other liquid assets and cannot raise cash quickly. It has been argued that lenders extending security credit in fact look not only to the collateral offered, but also to the other assets and general creditworthiness of the borrower. If this is true, highly margined credit and accentuated market downswings are only peripherally connected. See Moore, supra note 15, at 164.

\textsuperscript{29} The pyramiding scenario described in the text occurs when the loans involved are both purpose and security-collateralized. In a situation involving security-collateralized nonpurpose loans, borrowers retain the ability to maintain highly margined credit, by increasing their loan balances as securities prices rise. Thus, in a downswing, the possibility of a quickly triggered chain reaction remains. In a rising market, however, there is no direct upward pressure on securities prices, since the additional borrowing capacity is not being used to purchase securities. Pyramiding does not occur in the context of purpose loans that are not security-collateralized.
purchasers can exert an inflationary pressure on prices "immensely disproportionate to their numbers," and wholly "out of proportion to the amount of money invested." Although this view is subject to serious empirical challenge, it has proved to be the most enduring and persuasive justification for adding selective control of security credit to the government's arsenal of economic policy weapons.

B. The Structure and Legislative History of Section 7

The preceding discussion suggested several possible objectives of security-credit regulation. To determine which of these objectives existing margin controls were designed to promote, it is necessary first to examine the structure and scope of the regulatory framework. This examination is especially important since the legislative history of the margin provisions is ambiguous at best.

Congress adopted the margin provisions of the Exchange Act primarily as a reaction to the belief that highly leveraged stock market speculation had contributed to the onset of the Great Depression. Section 7 focuses on the extension of credit at the "retail" level: the provision covers loans made by brokers, nonbroker members of national securities exchanges, banks, and other lenders who extend credit in the ordinary course of their business. Section 7(a) authorizes the FRB to regulate, in accordance with specified standards, "the amount of credit that may be initially extended and subsequently maintained on any security," in order to prevent "the excessive use of credit for the purchase or carrying of securities." Subsection (b) gives the Board discretionary power to raise or lower margin requirements. Subsections (c) and (d)

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31 Note, Federal Margin Requirements as a Basis for Civil Liability, 66 Colum. L. Rev. 1462, 1463 (1966).
33 See Stock Market Report, supra note 25, at 41-64.
34 See notes 49-57 and accompanying text infra.
35 See generally Bogen & Krooss, supra note 12, at 85-90.
38 The FRB may prescribe lower margin requirements than are specified by the statute if it deems the reduction "necessary or appropriate for the accommodation of commerce
and industry, having due regard to the general credit situation of the country" (15 U.S.C. § 78g(b)(1) (1970)); and it may prescribe higher requirements if it deems the increase "necessary or appropriate to prevent the excessive use of credit to finance transactions in securities" (id. § 78g(b)(2)).

Section 7(c)-(d) (15 U.S.C. § 78g(c)-(d) (1970)) provides in pertinent part:

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the [FRB] shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the [FRB] may prescribe . . .

(B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the [FRB] shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section . . . . This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, . . . (D) to a loan by a bank on a security other than an equity security, or (E) to such other loans as the [FRB] shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt . . . from the operation of this subsection and the rules and regulations thereunder.


Act of July 29, 1968, Pub. L. No. 90-437, 82 Stat. 452 (amending 15 U.S.C. § 78g (1964)). See generally Solomon & Hart, supra note 28, at 193-98. Furthermore, in the case of lenders subject to § 7(d), the amendment extended the FRB's authority to cover loans made for the purpose of purchasing or carrying any security.

The amendment favored brokers, since the prior wording of § 7(c)(2) completely prohibited them from extending credit on nonregistered (over-the-counter) securities. Banks, on the other hand, became subject to more comprehensive regulation. Bank loans for the purpose of purchasing or carrying over-the-counter securities, previously unregulated, fall under the amended language of § 7(d).
ent scheme still exhibits gaps in its coverage, and treats various lender classes differently. The accompanying table classifies the statute's current distribution of regulatory requirements according to loan purpose, type of collateral, and class of lender. In essence, section 7 draws a purpose/nonpurpose distinction, imposing controls primarily on the former category of credit:

**REGULATORY COVERAGE OF SECTION 7**

<table>
<thead>
<tr>
<th>COLLATERAL OFFERED:</th>
<th>equity securities</th>
<th>nonequity securities</th>
<th>nonsecurities or no collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>USE OF LOAN PROCEEDS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purpose (P)/Nonpurpose (NP)</td>
<td>P</td>
<td>NP</td>
<td>P</td>
</tr>
<tr>
<td>BROKERS</td>
<td>R</td>
<td>R</td>
<td>X</td>
</tr>
<tr>
<td>BANKS</td>
<td>R</td>
<td>NR</td>
<td>NR</td>
</tr>
<tr>
<td>OTHER LENDERS</td>
<td>R</td>
<td>NR</td>
<td>R</td>
</tr>
</tbody>
</table>

R: regulated  X: prohibited  NR: not regulated

Significantly, the section's failure to reach a large portion of security-collateralized loans renders it structurally inconsistent with two of the three basic rationales offered for margin regulation: borrower-protection and lender-protection both require an approach that focuses on loan collateral. Only macroeconomic objectives are furthered by the statute's "purpose" orientation.

As another result of the 1968 amendment, the applicability of § 7(c), previously restricted to "any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member" (15 U.S.C. § 78g(c) (1964)), was extended generally to "any member of a national securities exchange or any broker or dealer" (15 U.S.C. § 78g(c) (1970)).


See notes 45-46 infra; text accompanying notes 81-83 infra.

See Special Study, supra note 16, at 16. Note, however, that § 7 covers nonpurpose credit extended by brokers, and does not cover purpose credit extended by banks on nonsecurity securities—both relatively unimportant subclasses of security credit.

Specifically, § 7 excludes both nonpurpose security-collateralized loans made by banks and other nonbroker lenders, and purpose loans made by banks on nonsecurity securities. The former exclusion is of considerable importance given the large amount of security credit involved. See Bogen & Krooss, supra note 12, at 138-40; Special Study, supra note 16, at 17.

See text accompanying notes 14-16 supra.

Two of the macroeconomic rationales for regulating security credit—maintaining funds for "productive" uses (see text accompanying notes 17-20 supra), and facilitating the implementation of monetary policy (see text accompanying notes 21-24 supra)—are prima-
To some extent at least, an examination of the legislative history of section 7 supports the conclusion that promotion of broad allocational policies, rather than concern for the welfare of individual market participants, underlay the statute's enactment. In seeking to determine Congress's intent in adopting section 7, courts and commentators have singed out a particular passage from the mass of legislative history. This appears in a committee report on the bill that later became the Exchange Act:

The main purpose of these margin provisions . . . is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.

The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market. 49

rily concerned with purpose credit, and are therefore consistent with the structure of § 7. The third macroeconomic rationale—reducing securities-market volatility (see notes 25-33 and accompanying text supra)—focuses to a greater extent on security-collateralized credit. Consider the following excerpt from an SEC study:

It would seem that, strictly from the point of view of safeguarding the securities markets against the risk of forced sales of collateral, the need for public control, in the form of an initial margin requirement, is no less in the case of a nonpurpose loan than in the case of a purpose loan.

In relation to the concerns of the FRB, charged as it is with broader economic aspects of security credit control, the purposes for which investors borrow may be of primary significance. The purpose standard is most relevant to those aims of margin controls that transcend protection against an uncontrolled, self-feeding decline; it relates primarily to more general considerations of credit and economic regulation.

SPECIAL STUDY, supra note 16, at 18.

Also noteworthy is the specific language of § 7, which refers to the need for "preventing the excessive use of credit for the purchase or carrying of securities" (15 U.S.C. § 78g(a) (1970)), and for accommodating "commerce and industry, having due regard to the general credit situation of the country" (id. § 78g(b)).

49 HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT ON H.R. 9323, H.R. REP. No. 1383, 73d Cong., 2d Sess. 8 (1934). The report is considered to be "the most authoritative legislative document concerning the bill which later became the Securities Exchange Act." Note, supra note 31, at 1468 (footnote omitted).
While the report is unequivocal in viewing the facilitation of broad macroeconomic control as the principal purpose of the margin provisions, it speaks ambiguously on the degree of significance to be accorded the investor-protection rationale for regulation. The "byproduct" language has been cited both to support the finding of a legislative intent to safeguard the small investor, and to deny any such intent. Those who argue that Congress intended to protect investors find additional support in a passage from the testimony of Thomas G. Corcoran, a drafter of the Exchange Act, before the Senate Committee on Banking and Currency:

One [purpose of the margin provisions] is to protect the lamb; another, and probably the more important of the two, although it does not appeal to one's human instincts as completely, is the protection of the national business system from the fluctuations that are induced by fluctuations in the market, which in turn stem back to this very exquisite liquidity you get when you have a lot of borrowed money in the market.

Reliance on Corcoran's statement, however, seems misplaced—the testimony refers to the content of certain early bills, whose schemes of margin control were concededly aimed at protecting investors as well as safeguarding the economy. Only at the conclusion of extensive hearings on these bills, while a conference committee attempted to iron out the differences between the Senate and House versions, did it become apparent that no single regulatory framework could accommodate both sets of objectives.

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54 The early proposals, for example, would have given the regulatory authorities discretion only to lower the maximum loan values set by the statute (i.e., power to increase the margin requirements, but not to relax them). See Bogen & Krooss, supra note 12, at 91; Note, supra note 31, at 1469.

55 Nevertheless, in a report prepared after the passage of the Exchange Act, the Senate Committee on Banking and Currency indicated that § 7 was in part "intended to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin." S. Rep. No. 1455, 73d Cong., 2d Sess. 11 (1934). The Senate Committee's views, however, may be interpreted as a response to the rejection of its own version of § 7 by the conference committee. See Bogen & Krooss, supra note 12, at 90-91; Note, supra note 31, at 1471. See generally Bell v. J.D. Winer & Co., 392 F. Supp. 646, 653 (S.D.N.Y. 1975).
It is noteworthy that the statute as finally adopted vested regulatory power in the FRB, an agency with well-established responsibility for maintaining macroeconomic stability. The conferees rejected alternative proposals that would have placed authority in varying degrees with the Federal Trade Commission and the newly created Securities and Exchange Commission. Thus, although there is still ample room for debate as to which macroeconomic objectives section 7 was specifically designed to promote, it seems certain at least that Congress ultimately abandoned the objective of protecting individual investors.

C. Federal Reserve Regulations

The FRB has promulgated elaborate regulations to implement the provisions of section 7. Regulations T, U, and G cover the lending activities of brokers, banks, and other lenders, respectively; Regulation X prohibits borrowers from obtaining credit that violates any of the lender regulations. Because their content and operation are exceedingly complex, the following discussion merely seeks to summarize these regulations, highlighting the specific provisions that most often provide the basis for private suits involving margin borrowers.

Regulation T controls the purpose lending of "every broker or dealer, including every member of a national securities exchange," through a regulated system of customer "accounts." The typical margin purchase takes place in a "general account," as do all transactions for which no "special account" is provided. Regulation T assigns a "maximum loan value" to securities pledged as collateral in a general account, which is equal to a specified percentage of their market value. The Regulation's basic rule provides, in substance, that if there is no excess collateral in a customer's general account, any purchase of securities made by the

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56 See Bogen & Krooss, supra note 12, at 87, 94-96.
57 Compare id. at 98 (margin legislation designed to facilitate FRB's implementation of monetary policy), with Stock Market Report, supra note 25, at 41 (margin legislation designed to stabilize securities prices).
59 Id. §§ 221.1-.4.
60 Id. §§ 207.1-.5.
61 Id. §§ 224.1-.6.
62 A broker making a nonpurpose loan must obtain and accept in "good faith" the borrower's written statement that the loan is not for the purpose of "purchasing or carrying or trading in securities." Id. § 220.7(c).
63 Id. § 220.1.
64 Id. § 220.3(a).
65 Id. §§ 220.3(c), 220.8.
broker for the customer must be followed by a deposit in the account of cash, securities, or some combination of the two, in such quantities that the total of the cash and the maximum loan value of the securities deposited equals or exceeds the market value of the securities purchased.66 If the customer fails to make the required deposit "as promptly as possible and in any event before the expiration of 5 full business days following the date of [the] transaction,"67 the broker must make appropriate liquidating sales.68 The Supplement to Regulation T specifies the maximum loan value for particular classes of securities.69 The FRB amends these from time to time as economic conditions warrant.70

Of the special accounts permitted under Regulation T, by far the most important is the "special cash account," in which a broker may execute "bona fide cash transactions."71 A broker may purchase a security for a customer through a special cash account only if the account already holds sufficient funds, or the broker believes in good faith "that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment."72 In any event,

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66 Id. § 220.3(b)(1)(i). Consider the following example. Assume that a customer opens a general account with a broker and immediately orders stock with a market value of $10,000. Assume further that Regulation T assigns a maximum loan value percentage of 40% to the stock. If the customer deposits the purchased stock in his general account, the account will contain securities having a maximum loan value of $4,000. To comply with the basic rule for general-account transactions, the customer must (1) promptly deposit $6,000 in cash, leaving a debit balance of $4,000; or (2) promptly deposit additional stock with a market value of $15,000 (i.e., stock with a maximum loan value of $6,000), leaving a debit balance of the full $10,000; or (3) promptly deposit an appropriate combination of cash and securities.

Note that the term "loan value" is simply the complement of the term "margin requirement"—the purchase of a security with a maximum loan value of 40% of its market value requires an initial cash margin deposit of 60% of its market value (if only that security is pledged as collateral for the credit).

67 Id.

68 Id. § 220.3(e).

69 Id. § 220.8. "Margin equity securities," which include stock registered on national exchanges and stock on the FRB's list of "OTC [over-the-counter] margin stock," are currently assigned a maximum loan value of 50% of market value, in a general account. Significantly, equity securities that are not margin equity securities have no assigned loan value (in a general or any other account), and thus cannot serve as collateral for a loan made by a broker. Id. §§ 220.3(c)(2), 220.8(f). Registered bonds, convertible and nonconvertible, although lacking an assigned loan value in a general account, have assigned loan values in appropriate special accounts. Id. § 220.8(b),(c). Separate margin requirements apply to short sales. See id. § 220.8(d).


72 Id. § 220.4(c)(1)(i). When a customer sells a security without first tendering full
the broker must cancel or liquidate the transaction (or the unsettled portion thereof) if the customer fails to make full payment within seven days after the purchase. Analogously, a broker may sell a security for a customer through a special cash account only if the customer's account already holds the security, or the broker believes in good faith that the customer owns the security and will deposit it promptly. In contrast to the rule regarding purchases, however, the customer need not make delivery within any specific period.

Rather than make loans themselves, brokers often attempt to procure outside financing for their customers. Regulation T permits such arrangements, but only if they are "upon the same terms and conditions as those upon which [a broker under Regulation T] may himself extend or maintain such credit to such customer[s]." Although Regulation T specifically exempts the arrangement of most stock-secured bank loans from its coverage, a broker who, on a customer's behalf, arranges bank financing that is impermissible under Regulation U, thereby violates section 7 of the Exchange Act itself.

payment to the broker who purchased it for his account, he is engaged in the practice of "free-riding." The customer seeks to profit from a price rise, having made little or no cash investment. With certain qualifications, Regulation T requires that brokers impose a punishment of sorts on customers who engage in free-riding:

Unless funds sufficient for the purpose are already in the account, no security other than an exempted security shall be purchased for, or sold to, any customer in a special cash account with the [broker] if any security other than an exempted security has been purchased by such customer in such an account, and then, for any reason whatever, without having been previously paid for in full by the customer, the security has been sold in the account or delivered out to any broker or dealer during the preceding 90 days . . . .


12 C.F.R. § 220.4(c)(2) (1977). There are two important exceptions to the 7-day liquidation deadline. First, Regulation T extends the deadline to 35 days when a customer arranges to pay for purchased securities upon their delivery by the broker. Id. § 220.4(c)(5). Second, "an appropriate committee of a national securities exchange or a national securities association" may grant an extension to a petitioning broker under "exceptional circumstances." Id. § 220.4(c)(6).

A customer engages in a form of free-riding (see note 72 supra) when he sells securities through his broker that he does not own, intending to buy-in—at a lower price—before the settlement date. See Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 469 F.2d 1166, 1176-78 (8th Cir. 1972).


12 C.F.R. § 220.7(a) (1977).

See id. § 220.7(a)(1).

Regulation U's provisions for margin lending by banks closely parallel the treatment of broker lending under Regulation T. Regulation U's basic rule prohibits banks from extending credit in an amount exceeding the prescribed maximum loan value of the securities offered as collateral.\footnote{12 C.F.R. § 221.1(a)(1) (1977).} Understandably, Regulation U is less complex than Regulation T—under Regulation U, for example, it is unnecessary to provide for liquidation deadlines, or to set up anything analogous to the special cash account.\footnote{12 C.F.R. § 221.1(a)(1) (1977) (footnotes omitted).} In addition, however, there are a number of outright differences between the two regulations that merit special examination.

Regulation U covers only "credit secured directly or indirectly by any stock for the purpose of purchasing or carrying any margin stock."\footnote{12 C.F.R. § 221.1(a)(1) (1977) (footnotes omitted).} Thus, banks may extend unsecured credit or credit secured by collateral other than equity securities without restriction,\footnote{15 U.S.C. § 78g(c)(2) (1970); Regulation T, 12 C.F.R. § 220.8 (1977).} while the extension of such credit by brokers is regulated or wholly prohibited.\footnote{An SEC study explains the differences in treatment accorded banks and brokers as reflecting the greater tendency of banks to develop longstanding customer relationships and, when considering loan requests, to look beyond the specific collateral offered, to the general creditworthiness of the borrower. Special Study, supra note 16, at 19-20. See U.S. DEP'T OF THE TREASURY, supra note 43, at 50; Solomon & Hart, supra note 28, at 174.} Furthermore, banks make a large proportion of stock-collateralized loans for unregulated purposes,\footnote{Special Study, supra note 43, at 50; Solomon & Hart, supra note 28, at 174.} and as a practical matter are often unable to monitor the actual use of their loans; thus, the purpose/nonpurpose distinction is far more significant under Regulation U than under Regulation T. Regulation U includes a fairly detailed definition of the "purpose of a credit,"\footnote{12 C.F.R. § 221.3(b) (1977). See also id. § 221.101 (Interpretation).} and requires banks to obtain "purpose statements" from their customers in connection with all stock-secured loans.\footnote{Id. § 221.3(a).} Banks may rely on purpose statements accepted in "good faith" by their officers before credit is extended. To accept a statement in good faith, a
bank officer "must (1) be alert to the circumstances surrounding the credit and (2) if he has any information which would cause a prudent man not to accept the statement without inquiry, have investigated and be satisfied that the customer's statement is truthful." 87 A considerable number of private suits under Regulation U have focused on the alleged imprudent reliance of banks on false purpose statements filed by their customers. 88

Regulation G, promulgated in 1969 to fill an expanding gap in the coverage of the margin provisions, 89 applies to otherwise unregulated lenders meeting certain quantitative tests:

Every person [not subject to Regulation T or Regulation U] who, in the ordinary course of his business, during any calendar quarter ended after June 30, 1976, extends or arranges for the extension of a total of $100,000 or more, or has outstanding at any time during the calendar quarter, a total of $500,000 or more, in credit, secured directly or indirectly, in whole or in part, by collateral that includes any margin securities . . ., is subject to . . . registration . . . with the [FRB] . . .. 90

Apart from its registration requirements, the provisions of Regulation G correspond closely to those of Regulation U.

All three lender regulations share an important characteristic: they regulate initial margins only, 91 leaving regulation of maintenance margins to the stock exchanges, the National Association of Securities Dealers (NASD), and the lenders themselves. 92 Indeed,

87 Id.
90 12 C.F.R. § 207.1(a) (1977) (footnotes omitted). A registration requirement is appropriate because "other lenders," unlike banks or brokers, do not comprise a discrete and readily identifiable class. See Solomon & Hart, supra note 28, at 186.
91 Note, however, that the Exchange Act does not so limit the FRB's authority. Section 7(a) specifically permits (and indeed seems to require) regulation of "the amount of credit that may be initially extended and subsequently maintained on any security." 15 U.S.C. § 78g(a) (1970) (emphasis added).
92 The stock exchanges and NASD typically prescribe for their members maintenance margins of 25%. See, e.g., Rule 431(b)(1), 2 NYSE Guide (CCH) ¶ 2431; Rule 462(b)(1), 2 Am. Stock Ex. Guide (CCH) ¶ 9475; NASD Rules of Fair Practice, art. III, § 30 (Appendix A § 4), NASD Manual (CCH) ¶ 2180A. Of course, lenders may individually establish more stringent requirements as they see fit.

The significant disparity between the FRB's high initial margin requirements and lenders' lower maintenance margin requirements makes good policy sense: the larger the gap, the greater the price decline needed to trigger margin calls and attendant "anti-pyramiding" effects. See Special Study, supra note 16, at 10-11, 15; U.S. Dep't of the Treasury,
Regulation T explicitly provides:

Except as otherwise specifically forbidden by this [regulation], any credit initially extended without violation of this [regulation] may be maintained regardless of (1) reductions in the customer’s equity resulting from changes in market prices, (2) the fact that any security in an account ceases to be margin or exempted, and (3) any change in the maximum loan values or margin requirements prescribed by the Board under this [regulation]. In maintaining any such credit, the creditor may accept or retain for his own protection additional collateral . . . .

Of course, granting investors and lenders unlimited freedom to execute transactions in margin accounts whose loan values have fallen (or by withdrawal are made to fall) below the level of the outstanding loan balance would render the initial margin requirements meaningless. The regulations accordingly restrict the extent to which securities (or cash) may be withdrawn from accounts, where the accounts would be undermargined following withdrawal.

Several miscellaneous provisions appear in each of the lender regulations, and thus affect all lender classes equally. For example, all three regulations excuse violations attributable to good faith mistakes. Similarly, they all forbid lenders from making certain credit arrangements with other lenders. Perhaps the most important common thread running through the lender regulations, however, appears in their respective supplements. There, to ensure uniform treatment of borrowers, the FRB prescribes a single set of maximum loan value percentages for all regulated lenders.

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supra note 43, at 51, 54-56. Note further that the effective gap between the two sets of requirements may be greater than a simple comparison of percentages would indicate, since securities assigned a zero loan value under the FRB’s initial margin regulations will be given their fair market value for purposes of determining compliance with maintenance margin rules. See, e.g., Rule 431(b), (d)(1), 2 NYSE GUIDE (CCH) ¶ 2431; Rule 462(b), (d)(1), 2 AM. STOCK EX. GUIDE (CCH) ¶ 9472; NASD Rules of Fair Practice, art. 111, § 30 (Appendix A §§ 3, 4), NASD MANUAL (CCH) ¶ 2180A. See generally SPECIAL STUDY, supra note 16, at 6.

12 C.F.R. § 220.7(b) (1977). See id. § 220.7(e) (Regulation T does not affect rights of exchanges or national securities associations to prescribe maintenance margin requirements or more stringent initial margin requirements).

See id. §§ 220.3(b)(2), 221.1(b), 207.1(j)(1). See generally Solomon & Hart, supra note 28, at 175-76.

See 12 C.F.R. §§ 220.6(k), 221.3(h), 207.4(d) (1977). Under Regulations T and G, however, the mistakes must result from mere “mechanical” errors, and lenders must take action to correct the mistakes promptly upon discovery. Id. §§ 220.6(k), 207.4(d).

See id. §§ 220.7(a), 221.3(u), 207.4(e).

Id. §§ 220.8, 221.4, 207.5.

Of course, § 7 of the Exchange Act precludes the FRB from treating lender classes
D. Public Enforcement of the Margin Provisions

Under the Exchange Act, the Securities and Exchange Commission (SEC) bears the responsibility for public enforcement of both the FRB's margin regulations and the margin rules of the national stock exchanges and the NASD.\(^9\) Section 21 gives the SEC broad authority to conduct investigations,\(^10\) to enforce compliance through injunctions and writs of mandamus,\(^11\) and to assist the attorney general in criminal proceedings.\(^12\) Moreover, it has the power to censure, or to suspend or revoke the registration of any broker found to be in willful violation of section 7 or the FRB's implementing regulations.\(^13\) To discourage violations further, the SEC may publicize any evidence of unlawful activity uncovered in its investigations.\(^14\)

SEC enforcement does not, of course, provide redress for individual investors injured by margin violations. More important, the nature of margin regulation practically ensures that a large proportion of violations will go unreported. A lender and an investor will often willingly collaborate to avoid margin controls in anticipation of mutual profit. If favorable market movements bear out these expectations, neither party has an incentive to report the evasion. That margin violations may be "victimless crimes"\(^15\) in this narrow sense, however, does not justify lax enforcement. As already pointed out, widespread avoidance of the margin provisions may undermine important economic policies.\(^16\) Unfortunately, the SEC lacks sufficient resources to ferret out margin violations effectively; broker-dealer inspections have proved especially cursory and infrequent.\(^17\) In light of this apparent failure of pub-

(AND HENCE BORROWERS) WITH TOTAL CONSISTENCY. SEE TABLE IN TEXT ACCOMPANYING NOTES 45-46 SUPRA. MANY PORTFOLIOS WILL HAVE HIGHER "EFFECTIVE" LOAN VALUES FOR BANKS AND "G-LENDERS" THAN FOR BROKERS.

\(^10\) Id. § 78u(a)-(c).
\(^11\) Id. § 78u(d), (e).
\(^12\) Id. § 78u(d).
\(^13\) Id. § 78o(b)(4)(D). ADDITIONALLY, THE STOCK EXCHANGES AND THE NASD ARE CHARGED WITH DISCIPLINING MEMBERS WHO VIOLATE THE EXCHANGE ACT, THE FRB MARGIN REGULATIONS, OR EACH ORGANIZATION'S OWN MARGIN REQUIREMENTS. SEE ID. §§ 78f(b)(6), 78o-3(b)(7).
\(^14\) Id. § 78u(a).
\(^16\) See notes 17-33 and accompanying text supra.
lic enforcement, judicial willingness to allow aggrieved margin investors access to the courts is hardly surprising.

II
PRIVATE ACTIONS UNDER THE MARGIN PROVISIONS

A. The Pre-Regulation X Learning

I. Theories for Implication

Courts have offered three distinct rationales for sustaining the private claims of margin borrowers under the Exchange Act. Initially, rights to civil relief were recognized under a "tort" theory predicated upon an interpretation of the legislative intent of section 7,108 and under a "contract" theory, construing section 29(b) of the Exchange Act109 to permit borrowers' avoidance or rescission of certain disadvantageous agreements.110 More recently, courts have justified private recovery as an enforcement tool—an additional deterrent to evasion of the margin requirements.111

a. The tort approach. In applying a tort analysis to imply civil liability under a statutory provision, courts traditionally focus on the legislative intent underlying the provision and on the compensatory function served by recovery. Section 286 of the First Restatement of Torts formulates this approach:

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

(a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and
(b) the interest invaded is one which the enactment is intended to protect; and,
(c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests results from that hazard; and,
(d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action.112

112 RESTATEMENT OF TORTS § 286 (1934). See also RESTATEMENT (SECOND) OF TORTS § 286 (1965).
Thus, to imply a private cause of action under the margin provisions of the Exchange Act, courts applying this analysis must find a legislative intent to protect investors from losses attributable to lenders' margin violations. As suggested earlier, neither the structure of section 7 nor its legislative history supports this inference of congressional intent. Nonetheless, in Remar v. Clayton Securities Corp., the leading tort-rationale case in the margin-regulation area, the court cited the "byproduct" language used by the House Committee on Interstate and Foreign Commerce as persuasive evidence of Congress's subsidiary intent to protect investors, and consequently recognized the availability of civil relief. Subsequently, courts employing the tort rationale have indicated that traditional limitations on tort liability apply; thus, the plaintiff must demonstrate that the defendant's conduct both proximately caused his loss and exposed him to the particular risks contemplated by the drafters of section 7.

b. Section 29(b) avoidance or rescission. Section 29(b) of the Exchange Act provides in relevant part:

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract . . . made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . . .

The courts have shied away from an interpretation of section 29(b) that would require automatically that both parties to an offensive

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113 See notes 34-57 and accompanying text supra.
116 81 F. Supp. at 1017.

For a discussion of whether margin lenders may raise the defense of contributory fault, see notes 151-204, 250-69 and accompanying text infra.
119 15 U.S.C. § 78cc(b) (1970). Professor Loss has described remedies based upon § 29(b) as "perhaps more express than implied." 3 L. Loss, supra note 107, at 1759 (2d ed. 1961).
agreement be restored to their pre-contractual positions. Instead, they have held that the contract is merely voidable at the option of the "innocent party." Hence, when an agreement repugnant to the margin regulations proves advantageous to an investor, he may still enforce it; but when such an agreement proves disadvantageous, the (nonperforming) investor may avoid liability in a suit brought by the lender. Moreover, courts have held that section 29(b) supports an investor's affirmative action for rescission. An aggrieved investor who foresees difficulties in proving proximate cause may prefer such an action to a tort-based suit.

Whether invoked offensively or defensively, section 29(b) tends to produce harsh results. It is an unwieldy device, but one not entirely immune to judicial manipulation.

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124 Judge Friendly has said:

Despite the Draconian language, § 29(b) does not provide a pat legislative formula for solving every case in which a contract and a violation concur. Rather it was a
margin violations, courts have frequently endeavored to temper the section's effects. It has been held, for example, that equitable principles govern the application of section 29(b), and that the remedy granted thereunder must be adjusted accordingly.\textsuperscript{125} More controversially, perhaps, some courts have expressed a willingness to deny relief entirely under section 29(b) when the contract in issue does not explicitly violate the margin regulations. One case adopting this view, \textit{Billings Associates, Inc. v. Bashaw},\textsuperscript{126} arose out of a broker's delay in liquidating a delinquent customer's cash account until after the expiration of the seven-day period prescribed in Regulation T. The broker successfully sued on the purchase contract to recover the deficiency after liquidation, over the customer's defense of section 29(b) "voidability." The majority's curt refusal to apply section 29(b) to agreements that do not "by their terms" entail Exchange Act violations\textsuperscript{127} provoked a strong dissent:

It would be a simple matter for a broker to let it be known that he would not abide by the seven-day rule, but would allow his customers to pay for their cash security transactions in a variety of ways and over variable time periods. . . . The rendering uncollectible of debts incurred in proscribed credit extension would appear to be the effective manner of imposing sanctions contemplated by the statute looking toward the enforcement of the act, irrespective of whether there has been an explicit contractual arrangement which, by its agreed terms, requires a violation of the credit provisions of the act.\textsuperscript{128}

The federal courts have aligned themselves with the \textit{Billings} majority, endorsing the narrower construction of section 29(b).\textsuperscript{129}

\textsuperscript{125} See notes 192, 201-04 and accompanying text infra.
\textsuperscript{126} 27 App. Div. 2d 124, 276 N.Y.S.2d 446 (4th Dep't 1967).
\textsuperscript{128} 27 App. Div. 2d at 128, 276 N.Y.S.2d at 449-50.
\textsuperscript{129} \textit{See, e.g.}, Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485, 501-02 (S.D.N.Y. 1977); Newman v. Pershing & Co., 412 F. Supp. 463 (S.D.N.Y. 1975). In \textit{Newman} a customer sued to have his buy-order declared void under § 29(b) after his broker had failed to liquidate the purchase within the time limits prescribed by Regulation T. The court dismissed the action, stating:

Despite the seeming all-inclusiveness of [the language of § 29(b)], I am unconvinced that the performance of an otherwise legal contract, contrary to its terms, in a manner which violates Regulation T, will render the contract itself void
c. The enforcement rationale. The enforcement rationale for allowing private recovery centers on the recognition that the prospect of civil liability often motivates statutory compliance. This rationale carries the most weight where, as in the area of margin regulation, public-enforcement efforts have proved inadequate.\textsuperscript{130} Enforcement-based remedies trace their origins to the Supreme Court’s decision in \textit{J.I. Case Co. v. Borak},\textsuperscript{131} which recognized a private right of action running to investors under section 14(a) of the Exchange Act.\textsuperscript{132} Although the Court in \textit{Borak} dwelled to some extent on a demonstrated statutory purpose to protect investors,\textsuperscript{133} the Court’s underlying rationale for recovery transcends the traditional tort approach. Focusing on the deterrent effects of liability, the Court found that it was “the duty of the courts to be alert to

\textit{Id.} at 467. Nonetheless, the court refused to rest its decision solely on this basis. It fell back on the “inappropriateness” of voiding a purchase contract when the associated margin violation is “the result of human error, rather than any attempt to induce [the customer] to purchase securities he would not have otherwise acquired.” \textit{Id.}

Judge Friendly has also taken a narrow view of § 29(b). In his dissenting opinion in \textit{Pearlstein v. Scudder & German}, 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971), he rejected the possibility of the plaintiff’s obtaining restitutionary relief under § 29(b) (an issue not reached by the majority): “Here the contract was not in violation of any provision of the statute or any rule or regulation; its performance would not have involved any violation if [the plaintiff had paid his debts on time]; and the court is not here asked to enforce anything that constitutes a violation.” 429 F.2d at 1149.

In contrast, some courts have taken an overly expansive view of the reach of § 29(b). Consider, for example, \textit{Warshow v. H. Hentz & Co.}, 199 F. Supp. 581 (S.D.N.Y. 1961). The defendant broker had arranged for a finance company’s extension of credit for a customer’s purchase of securities. The customer, contending that the credit arrangement violated Regulation T, brought suit against the broker to rescind the purchase contract. Although the broker’s performance of the \textit{purchase contract} does not seem to have involved any violation of Regulation T, the court denied the broker’s motion to dismiss, finding the customer’s claim “specifically authorized by the Act.” \textit{Id.} at 582.

Finally, note that the \textit{Billings} controversy might not arise when a bank violates Regulation U by failing to investigate diligently the truthfulness of a borrower’s purpose statement. The loan agreement that the borrower seeks to avoid in such a case might be viewed as contravening Regulation U on its face, since the bank must investigate before any credit is extended. Under this view, the agreement is unlawful at its inception and may be voided under any interpretation of § 29(b). \textit{But cf.} \textit{Goldman v. Bank of the Commonwealth}, 332 F. Supp. 699, 707 (E.D. Mich. 1971) (quoted in text accompanying note 218 \textit{infra}) (despite rescission of illegal agreement under § 29(b), bank may recover loan deficiency on common-law theories of “money lent” or borrower misrepresentation), aff’d, 467 F.2d 499 (6th Cir. 1972).

\textsuperscript{130} See text accompanying note 107 supra. See generally Note, supra note 31, at 1475-76.
\textsuperscript{131} 377 U.S. 426 (1964).
\textsuperscript{133} See 377 U.S. at 431-32.
provide such remedies as are necessary to make effective the congressional purpose."\(^{134}\)

In the area of security-credit regulation, the strongest response to Borak's endorsement of enforcement-oriented implied remedies came from the Second Circuit. In its landmark decision in *Pearlstein v. Scudder & German*,\(^{135}\) the court recognized "the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission."\(^{136}\) Moreover, in explaining its decision to grant civil recovery, the court disclaimed reliance on the traditional tort analysis:

> Although the congressional committee report which recommended the enactment of Section 7 indicates that the protection of individual investors was a purpose only incidental to the protection of the overall economy from excessive speculation, it has been recognized in numerous cases since that time that private actions by market investors are a highly effective means of protecting the economy as a whole from margin violations by brokers and dealers.\(^{137}\)

Commentators have attacked the enforcement doctrine expounded by Borak and *Pearlstein* as supporting potentially unlimited liability.\(^{138}\) In the security-credit context, however, application of the doctrine need not subject margin lenders to strict liability—courts exercise considerable control over the breadth of the right implied. Rather, the danger inherent in an enforcement approach lies in the quasi-legislative role forced upon the judiciary. A court undertaking a Borak-type analysis must make a broad, policy-based decision as to the particular distribution of liability that best promotes the goals of a statutory scheme. Institutional shortcomings, however, render the judiciary ill-equipped to make such determinations. Courts lack the flexibility of legislatures in fashioning civil remedies; judicial creativity can only manifest itself in the relaxation of traditional common-law prerequisites to recovery.\(^{139}\)

\(^{134}\) *Id.* at 433.


\(^{136}\) 429 F.2d at 1141.

\(^{137}\) *Id.* at 1140 (footnote omitted).


\(^{139}\) A court could not, for example, simply decree that injured margin borrowers are entitled to treble damages, even though that rule of liability might be the most effective in securing overall compliance with the security-credit regulations. For a proposed statutory
More important, courts, unlike legislatures, lack the investigative tools necessary to make the complex empirical judgments that an enforcement approach requires. Thus, the Borak doctrine places uncomfortable demands upon the judiciary. The lack of enthusiasm with which some courts have received it in the security-credit area is easily appreciated.\[^{140}\]

A comparison of the holdings in *Meisel v. North Jersey Trust Co.*,\[^{141}\] a pre-Borak decision applying the tort rationale, and *Stonehill v. Security National Bank*,\[^{142}\] a case that relies heavily on Borak's reasoning, illuminates the implications of an enforcement-oriented approach. In *Meisel*, the plaintiff had deposited securities with a trust company, which wrongfully sold them through the defendant broker without the plaintiff's permission. The plaintiff based his claim for damages on the broker's alleged violation of the cash-account provisions of Regulation T. In granting the broker's motion to dismiss, the court said: "Section 7(c) was passed for the benefit of customers . . . . There was no customer-broker relation between plaintiff and [defendant]; so far as [defendant was] concerned plaintiff was not a member of the class protected by the statute . . . ."\[^{143}\]

change of liability rules, see ALI Fed. Sec. Code § 1414(a) (Tent. Drafts Nos. 1-3, 1974), under which a borrower who received credit in excess of the limitations would be entitled to recover from the lender no less than the interest he paid on his loan, regardless of whether he suffered actual damages.

\[^{140}\] See, e.g., Grove v. First Nat'l Bank, 489 F.2d 512, 514-15 (3d Cir. 1973) (per curiam) (defendant lender having contingently conceded appropriateness of private recovery in its brief, court refused to consider Pearlstein rationale for implied civil liability).

It may be noteworthy that a number of post-Pearlstein cases have continued to use the tort analysis in recognizing civil liability under the margin provisions. See, e.g., Landry v. Hemphill, Noyes & Co., 473 F.2d 365, 370 (1st Cir.), cert. denied, 414 U.S. 1002 (1973); Goldman v. Bank of the Commonwealth, 467 F.2d 439, 446 (6th Cir. 1972).


\[^{143}\] 218 F. Supp. at 277. A similar situation arose in Glickman v. Schweickart & Co., 242 F. Supp. 670 (S.D.N.Y. 1965), in which a broker arranged credit for a customer with a discount company, allegedly in violation of Regulation T. The discount company wrongfully converted the securities that the customer had pledged as collateral, and then became insolvent. In her suit against the broker, the customer sought to recover the value of her converted securities, apparently arguing that one purpose of Regulation T was "to protect investors against the acts—including conversion—of irresponsible financing institutions of the kind that would make it a regular part of their business to subsidize violations of the margin requirements." Id. at 672-73. The court granted the broker's motion to dismiss:

[T]he only harm which section 7(c) of the 1934 Act was designed, generally, to prevent was that which might befall an investor should he "spread himself too thin" and should the market fall, resulting either in the loss of pledged security or subjection to suit for inability to pay back loans.

Conversion of the pledged stock by the financing institution, however, was not the type of risk covered by section 7(c) . . . .
In *Stonehill*, the plaintiff lent shares to Fowler, who pledged them as collateral for a bank loan. The plaintiff also guaranteed Fowler’s debt to the bank. After Fowler defaulted on the loan, the plaintiff sued the bank for the return of his shares (through rescission of the loan) and for damages, alleging that the bank had violated the maximum loan value provisions of Regulation U. The bank counterclaimed for recovery on the guarantee. In denying the bank’s motion for summary judgment, the court said:

[T]he most compelling rationale for allowing private actions under Regulation U is the need to supplement action by the Federal Reserve Board to enforce compliance by banks with the margin requirements.

If the primary justification for a private action is not the protection of the borrower under § 286 of the Restatement [of Torts], then there is no reason for restricting the right of action to the borrower. Indeed, in order to promote the primary objective of aiding in the enforcement of Regulation U, it would seem most important to allow a right of action to the guarantor. If the guarantor is not allowed to sue for affirmative relief under Regulation U or to rely on the invalidity of the illegal loan under § 29(b) as a defense in an action on the guarantee, then a bank could violate Regulation U with impunity merely by obtaining a guarantor for its loans.¹⁴⁴

The court distinguished *Meisel* on two grounds. First, the plaintiff in *Meisel* “was not a party to a brokerage transaction which allegedly violated Regulation T”; the plaintiff in *Stonehill*, however, “as guarantor, participated to a sufficient degree in the allegedly unlawful loan transactions to allow him a right of action.”¹⁴⁵ Second, *Meisel’s* reliance on tort theory came before the Supreme Court’s decision in *Borak*, “which furnishes a more compelling rationale for the guarantor’s right of action.”¹⁴⁶

Application of the *Borak-Pearlstein* reasoning to the facts in *Meisel* arguably produces a result different from the one actually reached in that case. Margin violations of the type alleged in *Meisel* undermine the macroeconomic policies underlying the FRB regu-

¹⁴⁴ 68 F.R.D. at 31-32 (footnote omitted).
¹⁴⁵ *Id.* at 32-33. The issue of the necessary connection between parties in an allegedly illegal margin transaction has also arisen in suits under § 29(b). See, e.g., Natkin v. Exchange Nat’l Bank, 342 F.2d 675 (7th Cir. 1965) (plaintiffs who loaned shares to borrower for use as collateral in bank loan barred from invoking § 29(b) because plaintiffs and bank not in “privity of contract”); Peoples Nat’l Bank v. Fowler, 73 N.J. 88, 372 A.2d 1096 (in case involving same transactions as *Stonehill*, court indicated that “contractual or other legal relationship” with lender required for recovery), *cert. denied* *sub nom.* Peoples Nat’l Bank v. Stonehill, 98 S. Ct. 182 (1977).
¹⁴⁶ 68 F.R.D. at 33 n.15.
lations to no less an extent than margin violations relating to trans-
actions in which individual customers participate directly. Indeed,
any change in liability rules that even slightly increases the likeli-
hood or size of civil recoveries for particular margin violations
increases the deterrent effect on lenders. In its purest form, there-
fore, the enforcement theory would seem to require the greatest
possible judicial relaxation of traditional limitations on liability,
with the possible exception of contributory fault defenses. Thus,
if enforcement-oriented courts apply Stonehill’s notions of privity or
standing to bar investors’ recovery in certain cases, they are
more likely to be motivated by considerations of administrative
convenience or of limited judicial competence than by strict
adherence to the legislative policies of margin regulation.

2. The In Pari Delicto Defense

The most troubling question in cases dealing with margin vio-
lations is whether an investor’s participation in the allegedly illegal
transaction should bar relief. The extent of an investor’s connec-
tion with a particular violation can range from complete ignorance
of the facts and the relevant legal requirements to willful deception
of his lender. In the context of pre-Regulation X transactions, the
situation that has provoked the greatest judicial disagreement in-

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147 The relaxation of traditional tort standards of contributory fault, while possibly
increasing the deterrent effect on lenders, might also encourage investors to induce lend-
ers’ margin violations, thus reducing overall compliance. See Pearlstein v. Scudder &
German, 429 F.2d 1136, 1147-48 (2d Cir. 1970) (dissenting opinion, Friendly, J.) (quoted in
text accompanying note 177 infra), cert. denied, 401 U.S. 1013 (1971). Thus, a strict application
of the enforcement theory would seem to call for relaxing the traditional proximate
cause and privity requirements of tort law, but might still entail preserving the defense of
contributory fault.

On the other hand, a wanton expansion of the right of action under § 7 might deter
lawful margin lending to some extent and thus be ill-advised. Cf. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 40 (1977) (“shareholders may be prejudiced because some tender
offers may never be made if there is a possibility of massive damages claims for what courts
subsequently hold to be an actionable violation of § 14(e) [of the Exchange Act]”). But see
text accompanying note 294 infra.

148 See 68 F.R.D. at 32-33; note 145 supra.

149 One administrative consideration is the possibility that a radical expansion of civil
lender liability will clog the courts with spurious margin suits. Cf. Blue Chip Stamps v. Mano
Drug Stores, 421 U.S. 723, 740 (1975) (noting “the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5”). But see Note, A New Rationale for Imposing Private Rights of Action and Section 7 of the Securities Ex-
change Act of 1934, 1975 WASH. U.L.Q. 1202, 1230 (“credit violations hardly seem to be an
area that would generate a multiplicity of suits”).

150 See notes 138-40 and accompanying text supra.

151 See generally Comment, Civil Liability for Margin Violations—The Effect of Section 7(f)
and Regulation X, 43 FORDHAM L. REV. 93, 99-101 (1974); Note, supra note 138; Note, supra
note 105, at 150-56.
volves the investor who, without engaging in any deception, knowingly assents to his lender's deliberate evasion of the FRB regulations. The courts' attempts to resolve this problem implicate the basic policies underlying the application of the in pari delicto defense in the security-credit area.

a. Actions for damages. The earliest tort-based decisions implying private rights of action for margin borrowers treated the availability of contributory fault defenses as turning exclusively on the legislative intent of section 7. In Remar v. Clayton Securities Corp., for example, the court viewed the plaintiff's participation in a loan arrangement that allegedly violated Regulation T as irrelevant to imposition of liability on the lender: "Since the statute was passed for the benefit of people like plaintiff, and since the Legislature regarded him as incapable of protecting himself, he is not disabled from suing for the injury he sustained."

The court in Moscarelli v. Stamm, however, took a narrower view of section 7. The plaintiff investors sought recovery against a broker who allegedly extended credit in excess of Regulation T limitations. According to the broker, the investors conspired with several of its employees to "deceive" the broker into committing the violations. The court denied the investors' motion for summary judgment:

In construing [section 7(c)], one notes that only the exceptional statute is interpreted as intending to place the entire responsibility upon defendants for the injury which has occurred, and there is no reason to believe that this statute falls within that exception.

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152 In pari delicto is the contract-law counterpart of the tort defense of contributory negligence. For expository convenience, and because the use of one label or another does not affect the following analysis, the term "in pari delicto" will be used to refer to both concepts.


154 Id. at 1017. The court in Zatz v. Hertz, Neumark & Warner, 262 F. Supp. 928 (S.D.N.Y. 1966), reached a similar conclusion. The plaintiff investor in Zatz alleged that brokers and an unregulated factor had conspired in extending him illegal credit. The court rejected the argument that the investor's knowing consent to the illegal transactions precluded recovery:

If plaintiff can establish . . . a conspiracy at trial, to allow Factor's defense of in pari delicto would be tantamount to saying that factors, without risk to themselves, can conspire with brokers to enable the latter to evade Section 7 of the Act and Regulation T with the consent of the customer. This result would run counter to the congressional intent which is, in part, to protect small speculators who are regarded as incapable of protecting themselves.


156 Whether a deception had occurred turned on whether the broker was responsible for the deceptive acts of its employees. See id. at 460-61.
The primary purpose of Section 7(c) and Regulation T was to prevent excessive diversion of funds by speculation into the stock market. To permit a broker's customer, who conspires or aids and abets the broker in violation of the provisions of Section 7(c), to recover his losses from his broker, would defeat the very purpose of the section and the economic considerations which underlie its enactment. . . . It is fairly obvious that Congress did not intend to protect investors at all times and under all circumstances regardless of their conduct.

It follows that the broker's implied civil liability is not absolute but is subject to the traditional tort concepts of causation and contributory negligence or analogous conduct. . . . The issue of plaintiffs' participation in the statutory violations of the margin requirements presents a triable issue which cannot be determined by summary judgment.\textsuperscript{157}

If the court meant to deny the investors recovery only if they had "deceived" the broker—and this seems to be the extent of the court's holding, given the procedural setting—then Remar's analysis remains intact; the court merely anticipated later developments in the case law.\textsuperscript{158} Even "exceptional" statutes do not protect beneficiaries from the consequences of their own outright fraud. If, on the other hand, the court meant that an investor's mere knowledge or nonmisrepresenting inducement constitutes "contributory negligence," then it departed significantly from the reasoning in Remar. The investor-protection objective of margin regulation contemplates a statute that attempts to safeguard investors from their own negligence;\textsuperscript{159} if indeed section 7 seeks to protect investors, it should be included in the special class of legislation that eliminates contributory negligence as a defense in private suits. Moscarelli's deference to the economic goals of the margin provisions accentuates the decision's inconsistency with the tort-based theories developed in Remar. Under any interpretation, Moscarelli presaged the enforcement-oriented decisions to follow.\textsuperscript{160}

In an analogous case under Regulation U, Goldman v. Bank of the Commonwealth,\textsuperscript{161} the plaintiff borrower willfully misrepresented the purpose of his bank loan. The Sixth Circuit paralleled Moscarelli by couching a tort analysis in overly expansive language:

\textsuperscript{157} Id. at 459-60.
\textsuperscript{158} See notes 161-64 and accompanying text infra.
\textsuperscript{159} See notes 14-15 and accompanying text supra.
\textsuperscript{160} See notes 169-78 and accompanying text infra.
\textsuperscript{161} 467 F.2d 439 (6th Cir. 1972).
The present action is a common law action in tort to recover damages for violation of a federal statute or regulation. Common law defenses are therefore available to the defendant. . . . Because the District Court found that [the borrower] knew that the loans violated Regulation U, he ought not to be permitted to recover damages occasioned by his own wrongful acts. 162

Goldman's language, however, should not be viewed as the culmination of a trend restricting the private right to relief accorded investors. Contemporaneous tort-based decisions can be found to support the view that, given the protective purposes of section 7, even the sophisticated speculator should be cast in the role of a "wolf of Wall Street in sheep's clothing,"163 and is thus deserving of statutory protection. Not surprisingly, post-Goldman case law effectively restricts Goldman to its facts. 164

The Supreme Court has explicitly referred to enforcement considerations in determining the availability of the in pari delicto defense, although in a nonsecurities context. In Perma Life Mufflers, Inc. v. International Parts Corp., 165 auto-parts dealers brought a treble-damage suit against their franchisor, claiming that restrictive provisions in their sales agreements violated the Sherman and Clayton Acts. The franchisor argued that the dealers' active and knowledgeable pursuit of the allegedly offensive agreements barred recovery. In a plurality opinion, Justice Black refused to apply the in pari delicto defense:

There is nothing in the language of the antitrust acts which indicates that Congress wanted to make the common-law in pari delicto doctrine a defense to treble-damage actions, and the facts of this case suggest no basis for applying such a doctrine even if it did exist. . . . We have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes. . . . The plaintiff who

162 Id. at 446 (emphasis added). Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969), used different reasoning to reach a similar result. The court applied an enforcement rationale to bar the misrepresenting borrower's damage claim: "To allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act." 290 F. Supp. at 89-90.


reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding public policy in favor of competition.\textsuperscript{166}

The Court also noted that the dealers' "participation was not voluntary in any meaningful sense. . . . [M]any of the clauses were quite clearly detrimental to their interests . . . . [The dealers] apparently accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity."\textsuperscript{167} Three separately concurring Justices questioned, to varying degrees, the Court's enforcement-oriented rhetoric, preferring to base their decisions solely on the franchisor's greater culpability in the case.\textsuperscript{168}

*Perma Life* has had important repercussions in areas outside antitrust law. *Pearlstein v. Scudder & German*,\textsuperscript{169} already singled out as the first margin decision to predicate private recovery exclusively on an enforcement rationale,\textsuperscript{170} is also significant for its application of *Perma Life*'s in pari delicto analysis to a margin investor's lawsuit.\textsuperscript{171} The plaintiff in *Pearlstein* was a sophisticated investor trading in speculative issues. On two occasions his broker neglected to liquidate uncovered cash-account purchases as required under Regulation T. The plaintiff sued to recover the subsequent decline in the value of his investments. Reversing the trial court's judg-

\textsuperscript{166} *Id.* at 138-39.
\textsuperscript{167} *Id.* at 139.
\textsuperscript{168} See *id.* at 146 (concurring opinion, White, J.); *id.* at 147-48 (concurring opinion, Fortas, J.); *id.* at 149 (concurring opinion, Marshall, J.).
\textsuperscript{169} 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971).
\textsuperscript{170} See text accompanying notes 135-37 supra.
\textsuperscript{171} Although *Pearlstein* was the first case to apply *Perma Life*'s reasoning to the issue of whether a borrower who is merely knowledgeable can recover in a private margin suit, it was not the first margin case ever to consider *Perma Life*'s ramifications. In *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969), the trial court distinguished *Perma Life*, disallowing recovery to a misrepresenting borrower:

It is to be noted that in [*Perma Life*] the action for treble damages was based upon an express statutory provision. That is not the situation in the present case. It is also to be noted that in that case the Court noted that the plaintiffs as participating wrongdoers would themselves be subject to statutory civil and criminal penalties. That is not the situation in the present case. It is also to be noted that in that case it appeared that the defendants actively and knowingly participated in the claimed violations. That is not the situation in the present case.

290 F. Supp. at 89. The court went on to point out that, in the context of an implied private right of action, a determination of whether the in pari delicto defense should apply "must [take] into consideration the matter of supplementing the enforcement of the statute." *Id.* Cf. *Moscarelli v. Stamm*, 288 F. Supp. 453, 459-60 (E.D.N.Y. 1968) (quoted in text accompanying note 157 supra) (enforcement-oriented language used in denying summary judgment to allegedly deceitful plaintiff borrower; no reference to *Perma Life*).
ment for the broker, the Second Circuit held that the plaintiff's knowledge of the illegality of his broker's conduct would not preclude recovery:

[T]he defense of in pari delicto in securities law cases has been undermined by the recent antitrust case of [Perma Life] . . . .

Although Perma Life would apparently continue to deny recovery to plaintiffs who had not been coerced but who had benefited from the arrangement equally with the defendant, such a defense does not appear desirable in the securities area here involved, even when the investor may be shown to have had knowledge of margin requirements. Unlike the antitrust laws which forbid both seller and buyer to enter into a proscribed transaction, the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit. This fact appears to indicate that Congress has placed the responsibility for observing margins on the broker . . . .

The court distinguished Moscarelli and Serzysko v. Chase Manhattan Bank on the grounds that "the kinds of contributory fault there involved go beyond knowledge of the margin requirements to concealment or misstatement of material facts."

Although the result in Pearlstein is clearly defensible on enforcement grounds, the court's opinion is confusing in a number of important respects. First, the court suggests that knowledgeable parties to an illegal broker-customer margin arrangement are—in contrast to the situation in Perma Life—equally benefited. If so, strict adherence to the Perma Life holding would seem to compel affirmance of the district court's judgment for the broker. Second, the view that Perma Life would indeed deny recovery to all "equally benefiting" plaintiffs is open to question. The most plausible interpretation of Perma Life requires imposing liability solely as enforcement considerations dictate, regardless of whether the parties are in some sense equally culpable. Finally, the implications of Pearlstein's emphasis that brokers, not their customers, are the targets of margin legislation are unclear. In Perma Life, the Court underscored the statutory illegality of the plaintiffs' conduct to support the denial of the in pari delicto defense. Perhaps the Pearlstein court viewed section 7's assign-

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172 429 F.2d at 1141.


174 429 F.2d at 1142.

175 The Court stated in Perma Life: "[P]ermitting the plaintiff to recover a windfall gain does not encourage continued violations by those in his position since they remain fully
ment of responsibility to brokers as a congressional statement that customers can never be "equally at fault" in relation to their brokers. Of course, this view is necessary only if courts construe Perma Life narrowly. Alternatively, the Pearlstein court may have tried to mirror Perma Life's analysis by finding a congressional intent to bar the in pari delicto defense in the security-credit area. Although this approach makes sense in the context of an express statutory remedy like that provided by the antitrust laws, it seems futile to attribute such intent to a congress that certainly never foresaw the creation of implied civil liabilities under section 7.

In short, Pearlstein's treatment of the in pari delicto issue makes most sense in light of the enforcement orientation of the rest of the opinion and the similar orientation of Perma Life. Judge Friendly's oft-cited dissent in Pearlstein corroborates this view, since it focuses on the application of enforcement-based analytical techniques. His opinion also raises a number of fundamental empirical questions:

I doubt whether permitting the customer to shift the risk of market decline to the broker is generally either necessary or desirable as a means of furthering the primary purpose of § 7(c) . . . .

Even assuming that the purpose of § 7(c) would be served by a degree of private enforcement, I question whether the majority's free-wheeling approach will have the desired effect. As a result of it, speculators will be in a position to place all the risk of market fluctuations on their brokers, if only the customer's persuasion or the broker's negligence causes the latter to fail in carrying out Regulation T to the letter. Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win tails-you-lose." For these reasons . . . . I would not find . . . [Perma Life] . . . to be truly pertinent even if there had been more of a consensus among the Justices than there was.

In the context of damage actions, subsequent cases have done little

subject to civil and criminal penalties for their own illegal conduct." 392 U.S. at 139.

Following this reasoning, the court in Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969), in contrast to Pearlstein, found that the absence of statutory sanctions applicable to margin borrowers supports the recognition of the in pari delicto defense in security-credit contexts. See 290 F. Supp. at 89, quoted in note 171 supra.

176 See text accompanying notes 135-37 supra.

177 429 F.2d at 1147-48 (dissenting opinion, Friendly, J.) (footnote omitted).
to resolve the dispute between Pearlstein's majority and dissent.\footnote{178}

b. Relief based upon section 29(b). Courts view claims under section 29(b) as somewhat different from tort or enforcement-based claims. In a sense, however, section 29(b) is a gross enforcement device, expressly designed to secure compliance with the Exchange Act. Thus, it is not surprising to find that the Pearlstein line of authority carries considerable weight when margin investors seek to avoid their disadvantageous agreements. Some judges, eager to avoid unduly harsh results in applying section 29(b), have fashioned highly flexible standards for determining the effect of an investor's participation in an unlawful transaction.\footnote{179} Such flexibility, however, may also lead to inconsistent results.\footnote{180}

When an investor-borrower deceives his lender, courts considering section 29(b) claims—in sharp contrast to their unyielding posture on damage claims\footnote{181}—show a willingness to grant at least some relief. The issues raised by borrower deception commonly appear in the context of an action based on Regulation U, where the borrower has concealed from his bank the use of his stock-secured loan to purchase margin stock, and the bank has failed to investigate diligently the true use of the credit. In one such case, Serzysko v. Chase Manhattan Bank,\footnote{182} the court noted:

\footnote{178} Pearlstein's disposal of the in pari delicto issue receives support, for example, in Jennings v. Boenning & Co., 388 F. Supp. 1294, 1299-1300 (E.D. Pa.) (dictum), \textit{aff'd per curiam}, 523 F.2d 889 (3d Cir. 1975):

\[T\]his Court is of the opinion that the Pearlstein rationale is sound. . . . The Court should not be required to inquire into the subjective knowledge of each investor to determine his role in the violation, but should be required to determine only whether the broker, who deals with this Regulation on a daily basis, has violated Regulation T.


\footnote{180} See notes 217-27 and accompanying text \textit{infra}.

\footnote{181} See notes 155-64 and accompanying text \textit{ supra}.

The law tends to look with a jaundiced eye upon the claim of a deceiver that his victim should not have been deceived. However, in the case of the margin requirements here involved there is again involved the matter of the enforcement of a regulatory statute. Under the requirements of the margin regulations here involved, a lender in making a loan may not safely ignore the possibility of deceit on the part of the investor-borrower as to the use of the proceeds of the loan and to that end is required to exercise reasonable diligence under the circumstances in connection with the matter of the probable misuse of the proceeds of the loan on the part of the investor-borrower. 183

Accordingly, the court denied the bank's counterclaim for the unpaid balance due on the borrower's promissory notes. 184 In Tartell v. Chelsea National Bank, 185 however, the court in dictum reached a different conclusion on facts similar to those in Serzysko:

As Judge Friendly noted in Pearlstein . . . , the language of § 29(b) is, indeed, "draconian". Nonetheless, assuming arguendo that [the credit in question was tainted], § 29(b) would not void the loan agreement. . . . [W]hile the failure of [the bank] to exercise reasonable diligence rendered performance of the contract a violation, there is no indication that § 29(b) was meant to apply where there has been performance by the violator and the willful deceit of one party to the contract has been a primary and proximate cause of a negligent violation by the other party. . . . Application of § 29(b) in the instant case and refusal to look beyond its "pat formula" would be a disservice to the legislative intent and an injustice to [the bank]. 186

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183 290 F. Supp. at 90.
184 Accord, Goldman v. Bank of the Commonwealth, 467 F.2d 439, 446-47 (6th Cir. 1972), aff'd 332 F. Supp. 699 (E.D. Mich. 1971). Both Goldman and Serzysko held that the plaintiffs' deceitful conduct precluded recovery in damages. Goldman, 467 F.2d at 446; Serzysko, 290 F. Supp. at 89-90. Perhaps in granting the borrowers relief under § 29(b), the courts were attempting to do "rough justice." See Comment, supra note 151, at 104 n.82. It should be noted, however, that the bank in Goldman was allowed to recover the unpaid balance of the loan, the trial court citing common-law theories of "money lent" and borrower misrepresentation. See 332 F. Supp. at 706-07, quoted in text accompanying note 218 infra.
185 351 F. Supp. 1071 (S.D.N.Y.), aff'd per curiam, 470 F.2d 994 (2d Cir. 1972).
186 351 F. Supp. at 1078-79. The court explained further its rejection of the Pearlstein approach:

It is arguable that the broker deterrence theory of the majority in Pearlstein as applied to Regulation T has some utility in an appropriate [sic] Regulation U case. Insofar as Regulation T is concerned, however, the broker does not have to rely on investor information. Regardless of whether the investor has used friendly persuasion or misleading statements, the broker need only deny extension of credit beyond a seven day limit to insulate himself from liability. On the other hand, under Regulation U the bank must rely on investor information for the purpose
Cases involving violations of Regulation T reflect a similar disparity of opinion regarding the effects of a borrower's deception. The relevant Regulation T decisions are not precisely analogous to their Regulation U counterparts, however, since they typically involve misleading conduct of a fundamentally different nature. The Regulation U decisions uniformly concern borrower misrepresentation with respect to the contemplated use of a loan.\(^8\) In Regulation T cases, however, the borrower usually misrepresents his ability to make prompt deposits of cash or securities with his broker.\(^8\) A broker who relies on such misrepresentations in delaying the required liquidations is probably aware of his own violation of Regulation T. On the other hand, a bank relying on a customer's misrepresentations regarding the intended use of a loan is usually unaware of its violation of Regulation U. Moreover, although a borrower who deliberately conceals from a bank his intention to purchase securities with loan proceeds is presumably familiar with Regulation U, an investor who lies to his broker in order to obtain an extended payment deadline may be ignorant of Regulation T's liquidation requirements. Hence, cases arising under Regulation T offer more compelling reasons for allowing relief to deceptive borrowers.\(^8\) Nevertheless, although the applicability of section 29(b) in these cases is generally conceded, some courts have tended to deny borrowers complete relief. The Eighth Circuit's opinion in *Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*\(^9\) exemplifies this tendency. Naftalin, running a one-man brokerage operation, placed sell orders in special cash accounts with twenty-two different brokerage firms. Although Naftalin represented to the brokers that he owned the securities to be sold, he was actually engaged in "free-riding," intending to buy-in the securities following anticipated price declines. Prices began to climb, however, and

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\(^8\) Since brokers do not normally extend nonpurpose credit, they rarely encounter this sort of deception.

\(^8\) One Regulation T case involving misrepresentations more akin to those found in Regulation U cases is *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968), discussed in text accompanying notes 155-60 supra. The court noted that "plaintiffs' instigation or willful participation in [the margin] violations would preclude their recovery by rescission under Section 29(b)." 288 F. Supp. at 460 (dictum).


\(^{10}\) 469 F.2d 1166 (8th Cir. 1972).
Naftalin was forced to offer evasive and misleading excuses to the brokers for his delays in delivering the securities. When they finally discovered Naftalin's deception, the brokers covered his short positions at large losses and jointly filed an involuntary bankruptcy petition. In the bankruptcy proceeding, Naftalin sought to avoid the sales agreements under section 29(b), arguing that the brokers had violated Regulation T by failing to liquidate the transactions within the required time limits. The court agreed that if the brokers had violated Regulation T, section 29(b) was applicable:

It has been forcefully argued that granting relief to knowledgeable and deceitful investors such as Naftalin will merely exacerbate the evil by providing potential wrongdoers with a heads-I-win-tails-you-lose opportunity . . . . But, if the broker/dealer is aware that he will be saddled with liability for an unlawful extension of credit, he will surely be motivated to act diligently either to preserve his good faith belief in prompt delivery or to liquidate the transaction . . . . We have no doubt that under section 7 and Regulation T as presently structured, a broker/dealer who has entered into a special cash account transaction in good faith, but who has not acted diligently to sustain his good faith belief that prompt delivery will be made, cannot excuse his negligence by placing all the blame upon a customer that has deceived him.191

Naftalin was not permitted to avoid liability entirely, however:

[W]e cannot accept Naftalin's argument . . . that the sales contracts are absolutely void under section 29(b) of the Act . . . . It may be that in the context of this case Naftalin, as the customer, cannot be the violator since . . . the onus of complying with section 7 and Regulation T is entirely upon the broker/dealers. Nevertheless, we cannot perceive how, under any stretch of the imagination, Naftalin can qualify as an "unwilling innocent party" entitled to invoke section 29(b). To absolve Naftalin of all contractual obligations after [he] had instigated and perpetuated these illegal schemes would be an inequitable and gratuitous result . . . .

. . . [W]e think the more appropriate remedy is to limit [the brokers'] claims to the difference between the sale price of the securities and the price at which those securities could have been purchased if the transactions had been bought-in at the time when the implied duty of liquidation arose under . . . Regulation T.192

191 Id. at 1181 (footnote omitted).
192 Id. at 1181-82. See also Spoon v. Walston & Co., 345 F. Supp. 518 (E.D. Mich.)
On facts strikingly similar to those in *Naftalin*, the Supreme Court of Nebraska totally rejected the applicability of section 29(b), allowing a broker full recovery against its deceptive customer:

Section 29 of the . . . Exchange Act . . . has been interpreted to mean that a contract made in violation of the act is not void but voidable at the option of the innocent party. . . .

The plaintiff [broker] in this case did not handle the transactions as short sales because of the representation by the defendant [investor] that he owned the stock which was sold. . . . When the plaintiff discovered that the transactions were in fact short sales, the plaintiff demanded collateralization as required by the federal regulations . . . .

Under the facts in this case, the plaintiff and not the defendant is the innocent party. The contract is not voidable at the option of the defendant . . . .

Where a borrower merely knew of the illegality of a particular margin transaction, and did not engage in deceptive conduct, most courts would allow full relief under section 29(b). In *Avery v.*
Merrill Lynch, Pierce, Fenner & Smith, for example, the plaintiff investor "was not an "innocent "lamb" attracted to speculation by the possibility of large profits with low capital investment," but rather was aware of the margin requirements and nevertheless disregarded them." Yet the court permitted the plaintiff to rescind a sales agreement with her broker:

[M]ere participation in or knowledge of a violation without fraud or deceit is not enough to deny the plaintiff recovery. . . .

To allow the broker to plead contributory negligence or causation by the customer as the reason for a violation would remove the very heart of the legislation, for in every case of a violation the dealer could be heard to assert participation. . . .

The Court will not entertain a cacophony of blame on the part of the brokers and customers—each blaming the other for not meeting the requirements—the ultimate responsibility must be placed somewhere and Congress has indicated that it is with the brokers or dealers.

In an analogous case, a California state court, relying largely on considerations of statutory enforcement, allowed a knowledgeable borrower to avoid liability under section 29(b):

We hold no brief for [the borrower]. He was a sophisticated and knowledgeable investor whose improvidence cannot be laid at the feet of [the broker]. [The broker] was also sophisticated and knowledgeable. . . .

The public policy embodied in the [Exchange] Act is a strong one and the public interest to be considered transcends the question of who on [sic] this case is to bear the loss. . . .

Since the evil to be prevented can only occur when the lender makes the credit available, the only effective method of deterrence is to deny to the lender the right to recover.

Some courts, however, have indicated in dicta that they might deny relief to merely knowledgeable investors. Caldwell v. Genesco Employees Credit Association is illustrative. In permitting a borrower

spite his active misrepresentation also stand for the proposition that a merely knowledgeable investor may invoke the section. See notes 182-84 and accompanying text supra.

196 Id. at 681 (quoting Pearlstein v. Scudder & German, 429 F.2d 1136, 1148 (2d Cir. 1970) (dissenting opinion, Friendly, J.), cert. denied, 401 U.S. 1013 (1971)) (footnote omitted).
197 328 F. Supp. at 680-81.
and his wife to void a promissory note held by a "G-lender," the court said:

In the absence of some proof that [the borrower] had knowledge of the factual circumstances that determine the applicability of Regulation G, the court is unable to conclude that [the borrower] "knew" the loan was in violation of the margin requirements. Further, the court finds no evidence of fraudulent intent in the acquisition of this loan by plaintiffs.

... The court concludes that plaintiffs were innocent parties according to the cases applying the remedy of rescission under [section 29(b)], and therefore are entitled to have the promissory note declared void.²⁰⁰

It has been suggested that the equitable principles occasionally read into section 29(b) to temper borrowers' relief in Regulation T misrepresentation cases²⁰¹ should apply more broadly to take into account all factors bearing on "fault," including, presumably, a borrower's knowledge of illegality.²⁰² Thus, in Freeman v. Marine Midland Bank—New York,²⁰³ a Regulation U-based action, the court noted:

[A] court should apply principles of equity when considering a rescission action under section 29(b)... "In deciding how to fashion a remedy in the area of illegal bargains, the type and degree of illegality become highly important factors."... It is this Court's opinion that the determination of a remedy in this case under section 29(b) will require a careful balancing of the equities... It is possible that the conduct of both parties in this case might reflect some degree of culpability.²⁰⁴

It remains to be seen whether Freeman's flexibility will characterize the application of section 29(b) in margin cases generally.

²⁰⁰ Id. at 747.
²⁰¹ See notes 190-92 and accompanying text supra.
²⁰² Consider Judge Friendly’s dissent in Pearlstein: “Pearlstein's claim for restitution based on § 29(b) is, if anything, even less attractive [than his damage claim].... Equity and justice are qualities that Pearlstein’s claim conspicuously lacks.... Equity would leave the loss where it lies.” Pearlstein v. Scudder & German, 429 F.2d 1156, 1149 (2d Cir. 1970) (dissenting opinion, Friendly, J.), cert. denied, 401 U.S. 1013 (1971). Cf. Tartell v. Chelsea Nat'l Bank, 551 F. Supp. 1071, 1077 n.2 (S.D.N.Y.) (“equity and deterrence demand a balancing of guilt under Regulation U regardless of whether the borrower has been negligent or willful”), aff'd per curiam, 470 F.2d 994 (2d Cir. 1972).
²⁰⁴ Id. at 453 (quoting Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255, 1266 (4th Cir. 1974)).
3. Remedial Issues

Perhaps because courts face complex theoretical issues in deciding initially whether margin borrowers are entitled to any relief at all, they have given less than adequate attention to questions concerning the appropriate measure of relief. Rather than attempting to catalogue the various situations in which remedial issues may arise, the following discussion examines recurrent themes that have posed analytical problems for the courts.

Questions of causation consistently trouble courts in margin cases. In particular, conceptual difficulties arise when an investor suing for damages claims that he was induced to enter into a margin transaction by his lender's offer of illegal credit. The leading case to consider this type of claim is Landry v. Hemphill, Noyes & Co. The plaintiff investor alleged that his broker had executed various transactions on his behalf although the collateral in his margin accounts was insufficient under Regulation T. It appeared, however, that the credit capacity of the investor's accounts on the date of a particular short sale would lawfully have supported a smaller similar transaction. The broker therefore sought to limit its liability on the short sale to the difference between the investor's actual market losses and the losses that the investor would have sustained had he entered into the smaller, lawful transaction. The court, however, rejected this reasoning:

The attractiveness of margin trading arises from the possibility of realizing quick profits on a relatively small capital investment. Thus, it is purely speculative to assume that, because an investor is demonstrably willing to purchase 100 shares of a security on a particular cash payment, he would make the same capital investment in anticipation of the profits on an 80 share acquisition. We therefore hold that once a Regulation T plaintiff establishes that he has been induced to enter a transaction by an illegal extension of credit, he may recover any losses sustained thereon, regardless of whether a smaller transaction in the same security would have been consistent with the margin requirements. In so holding, we resolve a highly intangible issue of proximate cause "in favor of those the statute is designed to protect." Similarly, a court might question a bank's argument that a customer seeking damages for the bank's violation of the maximum

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205 In most cases of this sort, the lender-investor agreement is unlawful "on its face"; hence, on a § 29(b) claim, even a court reading that provision narrowly must grant relief. See notes 124-29 and accompanying text supra.


loan value provisions of Regulation U would have taken out a smaller loan to purchase the same issues if the bank had insisted on compliance with Regulation U.\textsuperscript{208}

The liquidation deadlines of Regulation T raise their own unique questions regarding the appropriate relief for aggrieved margin investors. It is clear that in an action for damages, a broker who fails to observe the relevant time limits may be held liable only for market losses sustained after the deadline; no causal link exists between the broker's violation and any pre-deadline losses.\textsuperscript{209} Similarly, a broker cannot be held responsible in damages for losses occurring after the customer deposits, albeit tardily, the required amounts.\textsuperscript{210} Should similar restrictions apply when a margin borrower seeks relief under section 29(b)? Although the provision

\textsuperscript{208} A numerical illustration is helpful. Assume that an investor buys $10,000 worth of XYZ stock (margin stock) after arranging with a bank to pledge the stock for a loan of $7,000. The investor has put up $3,000 in cash to effect the purchase. Assuming further that Regulation U assigns a maximum loan value of $4,000 (40\%) to the stock, it is clear that the bank has acted unlawfully in extending as much credit as it did. If the market value of the stock falls by 20\% to $8,000, the investor may sue the bank for damages of $2,000, alleging that he would not have purchased any XYZ stock without the inducement of the bank's liberal credit offer. The bank, however, would point out that the investor's cash outlay of $3,000 would have permitted a legal loan of $2,000; that is, the investor could have purchased $5,000 worth of XYZ stock, which, when pledged as collateral, would have supported a lawful loan of $2,000 (40\% of $5,000). In that event, the total market value of the investor's stock would have fallen to $4,000 and the investor would have suffered a loss of $1,000. Thus, the bank would argue that the investor's damages should be limited to $1,000—the difference between the loss he actually suffered ($2,000) and the loss he would have suffered ($1,000).

\textsuperscript{209} See Pearlstein v. Scudder & German, 346 F. Supp. 443, 453 (S.D.N.Y. 1972), rev'd on other grounds, 527 F.2d 1141 (2d Cir. 1975) ("Pearlstein II").

\textsuperscript{210} See Bell v. J.D. Winer & Co., 392 F. Supp. 646 (S.D.N.Y. 1975). In Bell, the court stated:

In this case, the initial margin requirements were satisfied only days after they should have been and months or years before the [pledged securities] . . . declined in value. Perhaps even a de minimis violation of Regulation T can never be cured for purposes of foreclosing enforcement actions by the SEC, but surely it can be cured for purposes of defeating a federal implied private claim for relief. Once the initial margin requirements are met without objection, the violation can no longer be considered proximately connected with a decrease in market value in the distant future. To consider such a violation the proximate cause of an investor's loss under such circumstances would do far more to impede than to promote the purposes of the federal securities laws. It would mean that any time a broker violated the margin requirements in any way, the transaction would be voidable forever thereafter, regardless of the broker's attempts to cure the violation. This principle might well inspire investors to encourage relatively insignificant infractions so that they could never lose.

\textit{Id. at 652} (footnote omitted). Cf. Pearlstein v. Scudder & German, 527 F.2d 1141, 1146 (2d Cir. 1975) ("Pearlstein II") (broker's liability for failing to meet Regulation T cash-account deadline held not to include losses incurred after receipt of full payment, or—where broker was not in possession of securities and hence could not liquidate—after date of entry of judgment in broker-instituted suit).
seems to speak in absolute terms, at least one commentator has argued that its language embodies causation-based limitations. According to this argument, section 29(b) applies only because a broker's failure to liquidate promptly constitutes the "continuance of a relationship" in violation of Regulation T; thus, the only rights to be voided are those accruing after the deadline, when the broker-customer relationship becomes unlawful. This interpretation of section 29(b) has not received explicit judicial endorsement, but one court has granted the suggested remedy on another theory.

Regulation T's liquidation provisions raise a second set of remedial issues. Specifically, should courts reduce a borrower's recovery to reflect his partial deposits of cash or securities with his broker? By its terms, Regulation T requires timely liquidation of only the unsettled or undermargined portions of transactions. It is clear that a margin borrower cannot hold his violating broker liable in damages for more than the losses attributable to the broker's failure to effect the particular partial liquidations required. Should the same limitations apply to borrowers' claims under section 29(b)? Persuasive authority suggests that they should not.

Significantly, section 29(b)'s provision for the voiding of agreements offensive to the margin requirements does not suggest an unambiguous standard of relief. Although most courts read the

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211 See Comment, supra note 151, at 102 n.76.

212 Id.


214 For special cash accounts, Regulation T provides: "In case a customer ... does not make full cash payment ... within 7 days ... the [broker] shall ... promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof." 12 C.F.R. § 220.4(c)(2) (1977) (emphasis added). Analogous "partial liquidation" language covers general-account transactions. See id. § 220.3(e).

215 See Pearlstein v. Scudder & German, 527 F.2d 1141, 1146 (2d Cir. 1975) ("Pearlstein II"): "[U]nder [Regulation T] S & G was not obliged to sell the entire bond purchase but only to liquidate the unsettled portion of the transaction. Hence, S & G's liability should be in the proportion that the unsettled amounts bore to the total purchase price."

216 See Avery v. Merrill Lynch, Pierce, Fenner & Smith, 328 F. Supp. 677 (D.D.C. 1971). In Avery, the plaintiff executed through her broker a short sale of 500 shares. As of the deadline for bringing accounts up to margin, the plaintiff had deposited $14,025 in her account with the broker, some $925 short of the amount needed to meet the margin requirement under Regulation T. At the deadline, the broker became responsible for buying-in enough stock—40 shares—to meet the requirement. The broker delayed for about a week, however, then liquidated the entire short-sale transaction. During this time, the market price of the stock rose, to the plaintiff's detriment. The plaintiff sued to rescind the entire short sale under § 29(b), while the broker sought to limit the plaintiff's recovery to the loss incurred on the 40 shares that the broker was required to buy-in. The court awarded summary judgment to the plaintiff.
section as compelling the complete discharge of contract liabilities running from margin borrowers to their lenders, there is some support for the adoption of more conventional notions of "the status quo." In *Goldman v. Bank of the Commonwealth*, for example, the court stated with reference to a bank's right to recover on a loan agreement contravening Regulation U:

Plaintiff [borrower] has asked in effect . . . to rescind the contract or contracts entered into between him and Defendant bank. . . . It is virtual hornbook law that rescission of a contract requires the parties to place each other as nearly as may be in *status quo ante*. . . .

. . . [I]f the Court were to enter an order denying Plaintiff judgment on his complaint and denying Defendant judgment on the contractual cause of action laid forth in its counterclaim, the Court would then enter judgment for Defendant bank for the amount of the deficiency of the loan based upon either of two causes of action not voided by [section 29(b)], namely (1) a cause of action for money lent (. . . which apparently exists independently of any explicit oral or written contract between Plaintiff and Defendant) or (2) a cause of action for misrepresentation which it goes without saying is not a cause of action founded on contract.

Having entered a money judgment in Defendant bank's favor, levy could then be made upon the collateral, although the Court would have voided the security interest of Defendant in the collateral as required by [section 29(b)].

Under *Goldman*, a bank that violates Regulation U forfeits only the interest it has collected on its offending loans. Despite the obvious attractions of an approach that so avoids the arbitrary results otherwise produced under section 29(b), the case law shows little support for *Goldman's* remedial theory. Apparently, the view

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218 332 F. Supp. at 706-07. The plaintiff's having "intentionally engaged in an affirmative course of deceitful conduct" to obtain loans that he knew would be illegal (id. at 706) apparently influenced the court's decision to permit the bank's common-law recovery.
219 Consider the Sixth Circuit's opinion in *Goldman*: "The Bank collected only interest for making the loans. If the stock had gone up, as [the plaintiff] envisioned, he would have been a rich man. The Bank would not have participated in his riches, as it received only interest." 467 F.2d at 447. See also Note, supra note 31, at 1479.
that enforcement of the margin regulations requires "draconian" sanctions continues to prevail.

When margin borrowers combine damage claims and section 29(b) claims in a single action, courts must engage in a particularly careful analysis to avoid awarding double recoveries. In *Landry v. Hemphill, Noyes & Co.*,\(^{221}\) for example, the court granted the plaintiff investor recovery in damages against his broker,\(^{222}\) but then refused to permit the plaintiff to escape liability on the broker's counterclaim:

Plaintiff [argues] . . . that, in view of [the broker's] violations of Regulation T, its rights under the margin agreement were voided by § 29(b) . . . . [W]e find plaintiff’s argument to be wholly unsupportable in the present context. In calculating his damages on the Regulation T claim, plaintiff included the losses sustained on transactions made by the defendant in liquidating his account. Since these transactions resulted in the final deficiency, disallowing the counterclaim, while permitting an award of damages for the Regulation T losses, would in effect grant a double recovery to the plaintiff. Double recoveries of this nature are clearly prohibited by § 28(a) of the . . . Exchange Act . . . .\(^{223}\)

Not all courts so accurately perceive inconsistencies in the remedies sought by margin borrowers. Consider, for example, *Grove v. First National Bank*,\(^{224}\) a case involving facts analogous to those in *Landry*. The plaintiff purchased securities on credit from the defendant bank, pledging the securities as collateral. The credit exceeded the collateral's maximum loan value under Regulation U. When the value of the collateral fell below the outstanding balance on the loan, the bank sold the collateral, applying the proceeds to partially satisfy the debt. The plaintiff, apparently arguing that the bank's offer of illegal credit had induced him to purchase the securities, sued to recover the amount of their decline in value; the bank counterclaimed on the loan balance still owing. The trial court entered judgment for the plaintiff, and invoked section 29(b) to dismiss the bank's counterclaim. The Third Circuit affirmed:

[T]he Bank claims that the plaintiff has realized a "profit" by virtue of the manner in which the trial court formulated damages. We cannot agree.

\(^{221}\) 473 F.2d 365 (1st Cir.), cert. denied, 414 U.S. 1002 (1973).

\(^{222}\) For a discussion of the factual setting and award of damages in *Landry*, see text accompanying notes 206-07 supra.

\(^{223}\) 473 F.2d at 372.

The trial court computed the plaintiff's damages by measuring the decline in value of the . . . stock pledged . . . , from the dates on which the stock was pledged, until the date on which the stock was sold. . . .

. . . The amount asserted by the Bank to be a profit is also the amount that the Bank lost in its transactions with [the plaintiff], and is the subject of the Bank's . . . counterclaim.

If we were to accept the Bank's argument, it would have the effect of permitting the Bank to recover its claim for deficiency against the plaintiff despite the dismissal of its counterclaim. Such a result is contrary to the Congressional policy [expressed in section 29(b)]. . . . The effect of [that] provision is to preclude a lending bank from recovering a deficiency where the bank has violated Regulation U.225

In fact, the plaintiff in Grove realized a profit since his financial position was better after the recovery than it was before he took out the loan.226 To the extent that the court in Grove failed to recognize the element of profit in its award, its analysis is faulty. In seeking to effectuate the "Congressional policy" underlying section 29(b), the court ignored the paramount policy of disallowing punitive civil recoveries under the Exchange Act.227

B. The Effects of Section 7(f) and Regulation X

1. Legislative Background

As Pearlstein and other cases forcefully indicate, the margin legislation originally enacted placed the onus of compliance entirely on lenders. This one-sided state of affairs persisted until 1970, when Congress added section 7(f)228 to the Exchange Act. Section

225 489 F.2d at 515-16.

226 A simplified numerical example illustrates the remedial issues in Landry and Grove. Assume that a bank induces an investor to purchase $10,000 worth of stock by offering to lend him $8,000 on the purchase. The investor puts up $2,000 of his own money, purchases the stock, and pledges it as collateral for his loan. Assume now that the market value of the stock falls to $3,000. The bank sells the stock and applies the proceeds to the loan balance, resulting in a deficiency of $5,000. The investor sues for the $7,000 decline in value of the stock; the bank counterclaims on the loan agreement for the $5,000 deficiency.

Under Grove, the investor would recover the $7,000 and the bank's counterclaim would fail. The investor would thus realize a $5,000 "profit" over his $2,000 cash outlay. Landry, however, by allowing the bank to recover on its $5,000 counterclaim, would give the investor a net recovery of $2,000, which would match precisely his original outlay.


7(f) makes it unlawful for any "United States person" or his controllers

to obtain . . . a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if, under [section 7] or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited . . . .

Regulation X\textsuperscript{230} implements section 7(f) by making it unlawful to obtain credit that contravenes Regulations T, U, or G,\textsuperscript{231} except where the borrower makes an "innocent mistake" and takes corrective action promptly.\textsuperscript{232}

Congress enacted section 7(f) as Title III of the Bank Secrecy Act.\textsuperscript{233} A primary purpose of the legislation was to limit the use of secret foreign bank accounts and other financial services to evade American tax and securities laws.\textsuperscript{234} Although the passage of Title III seems to call into serious question the continued legitimacy of private investor actions under the margin regulations, Congress apparently ignored the matter of implied civil liability. Indeed, in hammering out the initial version of the Act, the House Committee on Banking and Currency never ventured into the area of security-credit regulation; instead, it focused on tax evasion and other "white collar" crimes facilitated by confidential bank accounts abroad.\textsuperscript{235} The Committee pushed for adoption of Title III only after hearing testimony that foreign-source, low-margin security credit seriously threatened the economic policies underlying the margin regulations.\textsuperscript{236} Even then, Congress concerned itself with

\textsuperscript{229} 15 U.S.C. § 78g(f)(1) (1970). "United States security" refers to a security "issued by a person incorporated under the laws of any State, or whose principal place of business is within a State." Id. § 78g(f)(2)(B).


\textsuperscript{231} Id. § 224.2(a)(1)-(3).

\textsuperscript{232} Id. § 224.6(a).


\textsuperscript{236} See Foreign Bank Secrecy and Bank Records: Hearings on H.R. 15073 Before the House Comm. on Banking and Currency, 91st Cong., 1st & 2d Sess. 175-77 (1970) (testimony of Irving M. Pollack). The Committee later stated in its report:

Americans and others, using the facade of secret foreign banks, can purchase securities in our market ignoring the Federal Reserve Board's regulations on margin requirements and for the purpose of evading income taxes. American com-
the margin activities of foreign banks rather than those of domestic lenders. Consequently, questions regarding the intended status of private margin actions after the passage of section 7(f) must be answered without the benefit of express legislative guidance.

2. Effect upon the Theoretical Basis for Implied a Private Right of Action

In light of section 7(f) and Regulation X, courts must reconsider the justifications for allowing margin borrowers to recover in companies are subject to takeovers or the acquisition of substantial interests by those about whom little or nothing is known. Criminal elements infiltrate and control substantial segments of American businesses through securities purchases and financing by secret foreign sources. Several of the recent corporate takeovers and acquisitions have involved security considerations in that defense contractors or other sensitive American industries became the target.


The bill would apply the margin requirements to borrowers regardless of whether they borrow from a domestic or foreign lender. The enforcement of the margin requirements with respect to purely domestic credit transactions would thus be enhanced since a borrower at times may deceive a lender by falsely certifying the purpose of a loan thus causing the lender to unknowingly violate the margin requirements.


Ironically, § 7(f) and Regulation X do not penalize borrowers who succeed in deceiving diligent lenders. If a bank or "G-lender" investigates diligently but fails to uncover a borrower's misrepresentation of the purpose of his loan, the lender has nevertheless complied with the lender regulations; the borrower therefore cannot have violated § 7(f) or Regulation X, since these provisions incorporate the lender regulations by reference. See Comment, supra note 151, at 112-13.

238 Cf. Solomon & Hart, supra note 28, at 212-13 ("[w]hile it seems clear that Congress did not intend to strip the small investor of [the] protection of civil recovery, it remains to be seen how the courts will interpret a statute which for the first time imposes on him a direct duty to obey margin regulations"); Comment, supra note 151, at 105 ("[i]t has been suggested that since the legislative history of section 7(f) does not reveal any intention to overrule existing case law, that law remains intact").
private suits. Certainly, the tort rationale has lost whatever validity it previously had: no one can seriously contend that a statute imposing criminal penalties on borrowers who participate in margin violations also seeks to protect those borrowers. Indeed, it can even be argued that by unhesitatingly imposing on borrowers a share of the responsibility for compliance with the margin regulations, Congress voiced its conviction that borrower-protection was not a goal of section 7 even as originally enacted. Under this reasoning, courts should no longer rely on tort theory to justify private recovery, even if the margin transactions in issue took place before section 7(f) and Regulation X became effective.

In contrast, the new provisions leave enforcement justifications for allowing private recovery largely intact. Although borrowers are now subject to criminal penalties for participating in margin violations, the prospect of civil liability should remain as effective as ever in deterring lenders from committing violations. To the extent that margin violations involve borrower participation, however, the possibility that borrowers will face criminal liability may lessen the need for private enforcement of the regulations.

Nevertheless, it has been argued that, because Regulation X makes an exception for "innocent mistakes" (see 12 C.F.R. § 224.6(a) (1977)), a "lamb" investor may still recover in tort. See Note, supra note 105, at 144-45. No such exception appears in § 7(f), however, and the intent of Congress, not that of the FRB, should determine whether civil recovery is permissible.

See Schy v. FDIC, [Current Binder] Fed. Sec. L. REP. (CCH) ¶ 96,242, at 92,629 (E.D.N.Y. Oct. 27, 1977) ("a fair reading of the amendment [adding § 7(f)] is a reaffirmance by the Congress of its refusal to extend protection to investors through a grant of a right of action") (emphasis added). Cf. Bell v. J.D. Winer & Co., 392 F. Supp. 646, 653 (S.D.N.Y. 1975) ("the Congress which passed § 7(f) was uncertain as to whether the original § 7 was ever intended to mean what the Pearlstein court interpreted it to mean"). One commentator has stated:

A body of law, such as the margin requirements, which has developed over a long period of time, obviously can have different purposes at different stages of development. . . . The recent trend in the area of margin regulation has been to shut off alternative sources of unregulated credit and to extend coverage to over-the-counter securities. Even if it is accepted that one of the original purposes of the margin requirements was to protect the individual investor, it can be argued persuasively that that purpose has shifted from protection of the investor to protection of the market from investors seeking to overextend themselves.

Comment, supra note 151, at 105-06 (footnotes omitted).


This view would call into question the implication of civil lender liability only for those transactions taking place after the effective date of Regulation X—the date on which the new public enforcement measures could be put into operation.
The case law under Regulation X generally indicates that civil lender liability survives. Some courts, by reaching the merits of borrowers’ claims, have implicitly acknowledged the continued vitality of private actions; they have merely inquired into the effect of Regulation X on the scope of the right implied. Other courts have expressly addressed the issue of implication. In one case, Neill v. David A. Noyes & Co., a federal district court concluded that enforcement-based arguments for allowing civil recoveries retain their persuasiveness:

Despite some recent changes in § 7, it is my opinion that the Pearlstein doctrine remains viable. . . . Innocent investors . . . continue to possess a valid cause of action for violation of margin requirements. The overall purposes of the Securities and Exchange Act of 1934 are best met by allowing this type of cause of action to continue.

The court in Palmer v. Thomson & McKinnon Auchincloss, Inc. agreed:

[T]here is nothing in the legislative history to suggest that Congress intended to overrule the Pearlstein decision by amending Section 7 of the Exchange Act. . . . [I]t seems plain that Congress did not intend to deprive all investors of a private cause of action for breach of the initial margin requirements.

. . . While the changes in the Act may have expanded the possible defenses of a creditor in a Section 7 action, I am not persuaded that the [Pearlstein] holding that borrowers possess an implied right of action for violations of the margin requirements should be changed.

On the other hand, the Tenth Circuit recently announced that “no private cause of action exists for violations of Regulation T.” In context, however, this statement appears unnecessarily broad; the court’s overall analysis reflects a finding that the plaintiff borrower was culpable to some extent, and seems to suggest that, on different facts, the court might have allowed recovery.

244 416 F. Supp. 78 (N.D. Ill. 1976).
245 Id. at 80.
247 Id. at 920.
249 See 549 F.2d at 169-70. Thus, the court seems to have confused the merits of the
3. **Effect upon the In Pari Delicto Defense**

   a. **Actions for damages.** Just as the enforcement rationale for private recovery arguably survives the promulgation of Regulation X, so the enforcement-oriented, *Perma Life-Pearlstein* approach to the in pari delicto defense also seems unaffected. The limits on the scope of the defense that were recognized as maximizing compliance with the margin requirements before Regulation X should continue to apply. Courts, however, are understandably repelled by the prospect of awarding civil recoveries to criminally culpable plaintiffs. Thus, many courts have repudiated *Pearlstein* by pointing to its outdated emphasis on the lender's exclusive "responsibility for compliance" under pre-Regulation X controls. Courts that take this line of attack against *Pearlstein* adopt a comparative fault approach to the in pari delicto defense, rather than a pure enforcement approach. Consider, for example, the opinion in *Lantz v. Wedbush, Noble, Cooke, Inc.*:

   *Pearlstein* . . . initially placed the burden of complying with the margin requirement of section 7 upon the broker. . . . Subsequent to *Pearlstein* Congress passed Section 7(f) . . . and the action with the threshold question of whether a private right of action exists at all. In *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969), the district court elaborated on this issue:

   There is a distinction between the matter of a person being within the general class of those who may bring a private action based on a violation of a regulatory statute and the right of such person to prevail on the merits in such an action when brought. To attempt to define the classes of investor-borrowers who may bring an action for the violation of Regulation U in terms of the extent of their sophistication would present difficulty. In many cases the determination of the extent of the sophistication of the investor-borrower would require a preliminary evidentiary hearing. It would seem that one who comes within the classification of an investor-borrower in connection with loans on registered securities may bring a private action for the damages allegedly sustained by him by reason of the violation of Regulation U subject to his being denied recovery on the merits. In connection with the merits the sophistication of a particular investor-borrower could, as in the present case, be of relevance in connection with the question as to whether his conduct should prevent recovery by him.

290 F. Supp. at 87.

250 See notes 242-47 and accompanying text supra.

251 See Note, supra note 105, at 154-57.

252 Recall, however, that the Supreme Court was willing to allow such recovery in *Perma Life*. See 392 U.S. at 139, quoted in note 175 supra.

253 For the relevant language in *Pearlstein*, see 429 F.2d at 1141, quoted in text accompanying note 172 supra. It has already been noted that the conceptual significance of Congress's particular assignment of compliance burdens is questionable. See text accompanying note 175 supra.

Federal Reserve Board promulgated Regulation X . . . . The thrust of these changes was to place the responsibility for observing margin requirements with the investor as well as the broker.

. . . . This court . . . finds that the defense of in pari delicto may be asserted for a violation of Section 7 and Regulation T.

In order adequately to assert the defense it is necessary for the defendant to show that the fault of the parties is "clearly mutual, simultaneous, and relatively equal."\(^{255}\)

Indeed, the very court that decided *Pearlstein* recently said, in a subsequent opinion in the same case:

> We note that in our prior opinion . . . emphasis was placed on the fact that "the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit." . . . However, the addition of section 7(f) . . . as well as the promulgation by the Federal Reserve Board of Regulation X . . . have now made it unlawful to obtain credit in violation of the margin requirements. The effect of these developments is to cast doubt on the continued viability of the rationale of our prior holding.\(^{256}\)

*Bell v. J.D. Winer & Co.*\(^{257}\) provides perhaps the most enlightening analysis of the new provisions' effect on the in pari delicto defense:

> [T]his court recognizes that § 7(f) was directed primarily at imposing responsibility for compliance with the margin requirements on investors in order to control the "infusion of unregulated foreign credit into American securities markets [which] can have a perniciously destabilizing affect [sic] on the market as a whole." . . . The primary motivation for the amendment was not

\(^{255}\) *Id.* at 654. See McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359, 365 (N.D. Ga. 1977): "[T]he addition of § 7(f) places in doubt the right of a knowing investor to recover for the margin violations of his broker. . . . The situation is quite different, however, where an investor is affirmatively misled by his broker into believing that his account is in compliance with Regulation T . . . ." Cf. Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977). In Palmer, the court indicated that the in pari delicto doctrine would bar recovery by all investors not coming within the "innocent mistake" exception to Regulation X: "The effect of Section 7(f) . . . is to restore to the broker certain defenses based upon comparative fault, such as in pari delicto. To prosecute an action successfully, a plaintiff must demonstrate his good faith —that he acted innocently without knowledge that the transaction violated the margin requirements." *Id.* at 921-22 (footnote omitted).

\(^{256}\) *Pearlstein* v. Scudder & German, 527 F.2d 1141, 1145 n.3 (2d Cir. 1975) ("Pearlstein II") (emphasis in original).

to impose responsibility for compliance with margin requirements on small investors using domestic money markets, but that is its effect. Similarly, there is no compelling evidence that the motivation for the original § 7 was to impose responsibility for compliance with the margin requirements exclusively on brokers and dealers, but that was its effect. Hence, while § 7(f) was probably not specifically intended to restore the in pari delicto defense which Pearlstein undermined, it must be interpreted as having had that effect to some extent.

... Thus, while § 7(f) and Regulation X may not overrule Pearlstein, they certainly indicate that the implied private right of action for violations of Regulation T should not be wantonly expanded.\textsuperscript{258}

Acknowledging the futility of searching for Congress's intent, the court apparently sought to strike a balance between pure enforcement considerations on the one hand, and the inherent unfairness of awarding relief to culpable, criminally punishable borrowers on the other.

b. Relief based upon section 29(b). It remains to be considered whether section 7(f) and Regulation X affect borrowers' claims under section 29(b). With respect to agreements that do not "by their terms" violate the margin regulations, courts interpreting section 29(b) narrowly\textsuperscript{259} will continue to allow recoveries by both lenders and borrowers suing to enforce contractual obligations.\textsuperscript{260} On the other hand, where an agreement is explicitly illegal, or the court takes the broader view of section 29(b), section 7(f) and Regulation X may have significant repercussions.

The doctrine of Mills v. Electric Auto-Lite Co.\textsuperscript{261}—that, under section 29(b), prohibited contracts are "voidable at the option of the innocent party"\textsuperscript{262}—presumes the existence of innocent and guilty parties. With few exceptions, the case law before Regulation X treated borrowers as innocent parties, based upon their lack of


\textsuperscript{259} See notes 124-29 and accompanying text supra.

\textsuperscript{260} Since § 7(f) and Regulation X incorporate the FRB lender regulations by reference, a contract that does not "on its face" violate one of the lender regulations cannot violate Regulation X or § 7(f).

\textsuperscript{261} 396 U.S. 375 (1970).

\textsuperscript{262} Id. at 387.
Courts were thus able to apply Mills freely in determining the proper remedy. Now that Regulation X places compliance burdens on knowledgeable borrowers, both parties to a margin transaction may be "guilty," and courts must decide whether relief is appropriate without authoritative guidance from Mills. The proper analysis, it seems, may be found in pre-Regulation X cases that looked to equitable principles for guidance in fashioning remedies under section 29(b). Those cases did not consider a margin borrower's freedom from statutory responsibility determinative on the issue of his entitlement to relief under section 29(b), but rather tempered the remedy according to broader notions of culpability. Because it tends to avoid arbitrary results, this approach remains as attractive and workable now as before Regulation X. Some commentators, however, have urged the courts to interpret the language of section 29(b) literally, at least to the extent of denying either party recovery on the contract in the "double-violation" situation. One federal district court has gone so far as to say, in dictum: "As Regulation X causes a borrower to be equally culpable with a lender where the violation is knowing, it would appear impossible for such a [borrower] to prevail in a rescission action under section 29(b) . . . ." The better view is the flexible one—a borrower's violation

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264 Since Regulation X incorporates Regulations T, U, and G by reference, it is impossible for a borrower to violate Regulation X without his lender simultaneously violating one of the other regulations. See notes 237 & 260 supra. On the other hand, because Regulation X makes an exception for borrowers' "innocent mistakes" (see 12 C.F.R. § 224.6(a) (1977)), a lender can violate the regulations without the oorrower's committing a concurrent violation.

Whether violation of an FRB regulation should be the sole criterion for judging a party's "guilt" is, of course, another question. See notes 267-69 and accompanying text infra.

265 See notes 190-92, 201-04 and accompanying text supra.

266 The "equitable" analysis is appropriate both when § 29(b) is invoked defensively (see, e.g., Naftalin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 469 F.2d 1166 (8th Cir. 1972)), and when it is invoked offensively in an action for rescission. Hence, in the context of margin litigation, the analysis conceivably applies in four situations: (1) lender sues borrower to enforce agreement, borrower raises § 29(b) defense; (2) borrower sues lender to enforce agreement, lender raises § 29(b) defense; (3) borrower sues under § 29(b) to rescind agreement with lender; (4) lender sues under § 29(b) to rescind agreement with borrower.

267 See, e.g., Comment, supra note 151, at 113; Note, supra note 105, at 148.

268 Freeman v. Marine Midland Bank—N.Y., 419 F. Supp. 440, 452 (E.D.N.Y. 1976) (erroneous reference corrected). The court's statement is puzzling, since the "rescission" that the plaintiff borrower sought was simply a declaratory judgment that his debt to the
of Regulation X should simply count as one of many factors in the "careful balancing of the equities" that precedes the determination of a remedy.

C. The Supreme Court's Toughened Stance on Implied Private Rights of Action

Two recent Supreme Court decisions narrow substantially the class of statutes under which private rights of action may be implied. In *Cort v. Ash*, the Court refused to recognize a shareholder's derivative right of recovery against a corporate director who had violated a criminal statute proscribing certain political contributions. In *Piper v. Chris-Craft Industries, Inc.*, the Court applied *Ash*’s analysis to the field of securities regulation, denying a defeated takeover bidder a cause of action against its successful competitor and the target company under the Williams Act. These decisions cast substantial doubt on the continuing viability of private damage actions under the margin provisions.

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270 422 U.S. 66 (1975).

271 See 18 U.S.C. § 610 (1970) (repealed 1976). The statute prohibited corporations from making a "contribution or expenditure in connection with any election at which Presidential and Vice Presidential electors ... are to be voted for."


273 Exchange Act § 14(e) (15 U.S.C. § 78n(e) (1970)). The statute provides in pertinent part:

'It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . .

274 See generally Note, supra note 149.

The *Ash* and *Chris-Craft* decisions should have no direct effect on the availability of
Under the approach developed in *Ash*, courts must ask four basic questions in deciding whether to recognize an implied private right of action under a criminal statute. First, "[I]s the plaintiff 'one of the class for whose especial benefit the statute was enacted'...?"275 The Court held in both *Ash* and *Chris-Craft* that the plaintiffs failed to qualify as members of such a protected class. The campaign-contribution statute at issue in *Ash* sought to free political elections from the corrupting influence of large corporate donations;276 the protection of shareholders was "at best a subsidiary purpose."277 Similarly, in *Chris-Craft*, the Court exhaustively analyzed the legislative history of the Williams Act and concluded that Congress passed the legislation to protect investors confronted by takeover bidders, not the takeover bidders themselves.278

*Ash*'s second inquiry—"[I]s there any indication of legislative intent, explicit or implicit, either to create...a [private] remedy or to deny one?"279—also demands investigation into a statute's legislative background. In neither *Ash* nor *Chris-Craft* was the Court able to discover any evidence that Congress had considered the question of civil liability with respect to the statutes in question.280

*Ash*'s third inquiry is perhaps the most troublesome of the four: "[I]s it consistent with the underlying purposes of the legislative scheme to imply...a remedy for the plaintiff?"281 Although both the *Ash* and *Chris-Craft* opinions answer in the negative, the analysis in neither is overwhelmingly convincing. In *Ash*, the Court

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275 422 U.S. at 78 (emphasis in original) (quoting Texas & Pac. Ry. v. Rigsby, 241 U.S. 33, 39 (1916)).

276 422 U.S. at 80-82.

277 *Id.* at 80.

Recently, in Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the Court reached a similar conclusion in refusing minority shareholders who had been "frozen out" in a short-form merger an implied private right of action under § 10(b) of the Exchange Act and Rule 10b-5. The Court stated:

[A] private cause of action under the antifraud provisions of the Securities Exchange Act should not be implied where it is "unnecessary to ensure the fulfillment of Congress' purposes" in adopting the Act. *Piper v. Chris-Craft Industries*. . . . As in *Cort v. Ash*, . . . , we are reluctant to recognize a cause of action here to serve what is "at best a subsidiary purpose" of the federal legislation.

*Id.* at 477-78.

278 430 U.S. at 24-35.

279 422 U.S. at 78.


281 422 U.S. at 78.
felt that allowing corporations to recover directors' unlawful contributions of the corporations' money "would only permit directors in effect to 'borrow' corporate funds for a time."282 Such a remedy, the Court went on, "might well not deter the initial violation, and would certainly not decrease the impact of the use of such funds upon an election already past."283 The discussion in Chris-Craft is somewhat more detailed. The Court first pointed out that a defeated tender offeror's recovery of damages against its successful competitor and the target company would not directly benefit (and might even hurt) tendering shareholders, who are clearly members of the class protected by the statute.284 The Court then went on to say:

[We cannot] agree that an ever-present threat of damages against a successful contestant in a battle for control will provide significant additional protection for shareholders in general. The deterrent value, if any, of such awards can never be ascertained with precision. More likely, however, is the prospect that shareholders may be prejudiced because some tender offers may never be made if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation of § 14(e). . . .

In short, we conclude that shareholder protection, if enhanced at all by damages awards such as Chris-Craft contends for, can more directly be achieved with other, less drastic means more closely tailored to the precise congressional goal underlying the Williams Act.285

Understandably, the Court's analysis is complex and tentative; in responding to Ash's third inquiry, the Court was forced to grapple with the same sorts of deterrence and enforcement arguments that have proved so controversial in the margin-regulation area.286

For its fourth and final inquiry, Ash asks: "[I]s the [remedy sought] one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"287 The Ash and Chris-Craft opinions both answer "yes." In Ash, the stockholder might have obtained appropriate relief by asserting in a state derivative

282 Id. at 84.
283 Id.
284 430 U.S. at 39.
285 Id. at 39-40.
286 See notes 130-50 and accompanying text supra.
287 422 U.S. at 78.
action that the corporate contribution was ultra vires, or that the
directors had breached a fiduciary duty to the corporation. 288 Similarly, in Chris-Craft, the Court noted that the tender offeror was
properly relegated to a common-law action for "interference with a
prospective commercial advantage." 289

These decisions fail to indicate clearly whether margin bor-
rowers continue to possess an implied cause of action. An appli-
cation of Ash's four-part analysis to section 7 of the Exchange Act
reveals both similarities and differences between that provision and
the statutes involved in Ash and Chris-Craft. As already noted, mar-
gin borrowers probably fail to qualify as intended beneficiaries of
section 7, particularly in view of the recent addition of section
7(f). 289 They certainly do not comprise the class for whose especial
benefit the margin legislation was enacted. Hence, with respect to
Ash's first inquiry, the margin borrower under section 7 occupies a
position analogous to that of the shareholder in Ash and the
takeover bidder in Chris-Craft. Furthermore, with respect to Ash's
second inquiry, it appears that Congress has no more indicated
its support or rejection of a private remedy under section 7 than it
has under the statutes in Ash and Chris-Craft. From this point on,
however, the correspondence between section 7 and its statutory
counterparts in the Supreme Court cases ends. Unlike the plain-
tiffs in Ash and Chris-Craft, a margin borrower suing under section
7 does not have an alternative common-law theory under which he
can secure analogous relief. More important, the utility of private
enforcement in furthering statutory objectives in the security-credit
context turns on considerations that are inapplicable in the con-
texts of the Ash and Chris-Craft statutes. Whether these distinctions
support the continued recognition of civil liability under the mar-
gin provisions requires closer scrutiny of the Supreme Court's
rhetoric, and reexamination of the enforcement value of private
margin actions.

Initially, it must be asked whether the enforcement arguments
for implied liability under section 7 are more persuasive than those
rejected in Ash and Chris-Craft. Undoubtedly, the prospect of civil
liability has at least some deterrent effect on margin lenders. Yet
some of the reasons advanced in Chris-Craft for rejecting private
recovery as a suitable tool for enforcing the Williams Act plausibly

288 Id. at 84.
289 430 U.S. at 40-41. See also Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977).
290 See notes 49-57, 228-41 and accompanying text supra.
Security-Credit Regulation

apply to margin regulation as well. Thus, as the Court indicated with respect to damages awarded to tender offerors, the deterrent value of awarding damages to margin borrowers “can never be ascertained with precision.” Furthermore, to paraphrase Chris-Craft, lawful and economically desirable margin borrowing may be curtailed “if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation” of the margin provisions. Although lawful margin transactions, like lawful tender offers, are indeed economically desirable, this latter argument fails to consider two important distinctions between margin trading and takeover bidding. First, damage recoveries for margin violations are rarely “massive”—margin lenders eventually liquidate transactions for their own protection, thereby limiting customers’ trading losses. Moreover, institutional investors, who make the largest transactions in the securities markets, are prohibited altogether from using security credit. Thus, damage awards in margin cases would probably never approach the $36 million judgment originally awarded in Chris-Craft. Second, margin lenders, unlike parties to a takeover bid, can easily determine in advance the legality or illegality of their conduct. The margin regulations, built around such objective features as maximum loan value percentages and liquidation deadlines, are far more predictable in their application than the Williams Act provisions involved in Chris-Craft. Thus, although permitting civil recoveries under the Williams Act might discourage lawful tender offers, it is unlikely that allowing such recoveries under section 7 deters lawful margin lending.

A final argument against allowing enforcement-based recoveries under the margin provisions appears in Judge Friendly’s dissent in Pearlstein:

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291 430 U.S. at 40. In noting the difficulties of measuring the deterrent effect of various schemes of private enforcement, the Court may have been expressing its uneasiness with the broad judicial discretion that inheres in a case-by-case determination of the scope of a civil remedy. See generally notes 138-40 and accompanying text supra.

292 430 U.S. at 40.

293 Security credit facilitates capital formation and enhances economic liquidity. See Bogen & Knooss, supra note 12, at 35-38. It is noteworthy, however, that prior to the Exchange Act’s passage various legislative proposals called for the complete prohibition of margin trading in securities. See id. at 86, 88, 89.

I doubt whether permitting the customer to shift the risk of market decline to the broker is generally either necessary or desirable as a means of furthering the primary purpose of § 7(c). Occasional and isolated violations of Regulation T do not threaten to cause a significant alteration in the allocation of credit in the economy; only widespread or repeated violations would pose a danger. But it is in just such situations that we may confidently expect application of the administrative and criminal sanctions provided by the Act. The economic purpose behind § 7(c) thus causes the provision to differ from those portions of the securities acts more directly aimed at protection of investors. With misleading proxy statements, for instance, one violation does threaten the purpose of the Act *pro tanto*, and since the SEC cannot catch all such violations before the fact, a privately imposed sanction, whether before or after, is appropriate.  

Whether rejection of civil liability under the margin provisions would give rise only to insignificant violations incapable of damaging the economy is not immediately clear. Certainly, the SEC’s long-standing support of private recoveries by margin borrowers warns against blind acceptance of Judge Friendly’s analysis.

Even if courts find that private enforcement is useful in the area of margin regulation, however, it is not entirely clear what weight this finding should carry. Ash nowhere suggests that any of the four factors relevant to the recognition of an implied right of action should receive special emphasis. The opinion certainly does not view a plaintiff’s membership in the statute’s class of intended beneficiaries as essential to recovery. Yet the Court’s language in *Chris-Craft* is troubling, for it suggests just such a weighted approach—an approach that, despite the looming shadow of *J.I. Case Co. v. Borak*, seems to vitiate the independent significance of enforcement considerations for implying private rights of action:

> The reasoning of [Borak and other] holdings is that, where congressional purposes are likely to be undermined absent private enforcement, private remedies may be implied in favor of...
the particular class intended to be protected by the statute.

... In Borak, the Court emphasized that § 14(a), the proxy provision, was adopted expressly for "the protection of investors," the very class of persons there seeking relief.

... Even though the SEC operates [here] under the same practical restraints recognized by the Court in Borak, institutional limitations alone do not lead to the conclusion that any party interested in a tender offer should have a cause of action for damages...

Taken at face value, the Court's language represents a radical departure from Borak's view of the courts as roving enforcers, free to imply causes of action whenever concerns of statutory compliance dictate. Indeed, after Chris-Craft, it appears that section 7's focus on national economic policy rather than on the interests of some discrete class of market participants may be determinative in foreclosing civil lender liability entirely.

Lower courts have not yet fully recognized the implications of Ash and Chris-Craft in the security-credit area. In several instances, they have continued without hesitation to imply private rights of action for margin violations. In Schy v. FDIC, however, a federal district court held generally that the Supreme Court's analysis effectively overruled Pearlstein, and, in the case at hand, barred a shareholder's derivative suit under Regulation U to recover losses incurred by a corporation in making a bank-financed tender offer. The court concluded that the plaintiff's claim satisfied only the last of Ash's four criteria—it was not one traditionally relegated to state law—and rejected the traditional enforcement arguments for private recovery. Re-

299 430 U.S. at 25, 32, 41.
302 Id. at 92,631.
303 Id. at 92,630.
304 [T]he [Exchange] Act provides for public oversight. The scheme contem-
regardless of the accuracy of its analysis, the court's approach is encouraging: it reflects a judicial willingness to subject the en-
plates Federal Reserve Board regulation of allowable credit and SEC enforce-
ment of the Board's dictates. Criminal penalties may be imposed for non-technical violations. . . . There is nothing that leads us to believe that the Congressionally designed administrative and penal sanctions are ineffective. Moreover, the use of extended credit to finance tender offers implicates further SEC involvement. . . . The extensive web of public enforcement procedures woven by Congress renders unnecessary any additional private weapon.

. . . We find nothing to indicate that public enforcement . . . is ineffectual. Whatever institutional limitations exist, they do not justify judicial implication of a private damage remedy.

Id. at 92,630-31. In contrast, consider the court's statement in Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977), in which the court held that Ash did not foreclose private margin suits: "Margin violations are in the nature of 'victimless crimes' which neither broker nor borrower is likely to report. The likelihood of administrative enforcement is therefore remote." Id. at 921.

The court in Schy went on to consider enforcement arguments with specific reference to Ash's requirement that the implication of a private remedy be consistent with the underlying purposes of the legislative scheme:

Nor can we say that a private remedy is even consistent with the legislative goals of section 7. Without extended analysis, the majority in Pearlstein . . . simply assumed that the threat of private suits would have a salutary policing effect. . . . But as the Supreme Court in Chris-Craft pointed out, the deterrent effect that massive awards may have can never be ascertained with precision. . . . To state, as did the Pearlstein . . . court, that the danger of a windfall gain to an unscrupulous investor is outweighed by the deterrent impact of a potential damage award overlooks the prospects [sic] inherent in a judicially implied right of action. The borrower, if vested with the right to sue, could invest borrowed funds, await the outcome of his investment, and then attempt to shift his losses under a regulation U claim. . . . The prospect of a free ride might encourage knowing investors to induce wrongful loans under the umbrella of protection afforded by a private right of action. Even where . . . the seed of a margin claim is not intentionally sown by the borrower at the outset, to the extent that he enjoys a no lose posture, it diminishes the incentive to scrutinize his loans for margin violations. . . . To now permit plaintiff to press a section 7 claim would not only fly in the face of a de-
terrent rationale, but in the face of Congress' desire to limit credit as well.


enforcement considerations underlying section 7 to more detailed scrutiny within the framework of the Supreme Court’s standards for implying private rights of action.

CONCLUSION

Since private recoveries under the Exchange Act’s margin provisions first received judicial recognition, debate has focused primarily on the nature of the right created, rather than on the threshold question of whether a right is properly implied at all. This failure to question the basic legitimacy of private margin suits reflects a fortuitous course of doctrinal development in the law of implied private remedies. The early margin decisions assumed that section 7, like many of the Exchange Act’s other provisions, was an investor-protection measure. Thus, courts initially employed traditional tort theory to imply civil liability under the section. During the mid-1960’s, skepticism regarding the asserted purposes of section 7 began to mount. The courts were faced with the choice of either revising their analysis or terminating investor recovery under the margin provisions. Conveniently, the Supreme Court provided a new line of justification by expressing its enthusiasm for enforcement-based private remedies. Courts quickly adopted the enforcement rhetoric in margin cases, and, by the time section 7(f) dealt the final blow to recoveries founded in tort, the enforcement rationale was firmly established.

The lack of controversy surrounding this substitution of theories for implying liability under section 7 stands in sharp contrast to the explosive disagreement over the proper scope of the liability implied. The question of whether margin lenders may raise the in pari delicto defense is responsible for provoking the most heated controversy. The passage of section 7(f), properly viewed, merely fuels this debate. Recently, however, the focus of judicial concern has shifted. The Supreme Court’s Ash and Chris-Craft opinions...
ions now cast doubt upon the enforcement rationale for creating civil remedies. Thus, for the first time in thirty years of private margin litigation, the very existence of civil liability under section 7 is being seriously questioned.

*Ash* and *Chris-Craft* reflect serious concerns about the judiciary's ability to exercise the broad discretion inherent in fashioning remedies based solely on enforcement considerations. Significant questions of institutional competence arise when parties who are not intended beneficiaries of a legislative scheme seek recoveries grounded on extrinsic statutory policies. Curtailment of judicial freedom to grant enforcement-based relief is particularly necessary in the context of section 7, since the underlying aims of this provision have never been obvious to judges. Admittedly, the case law is replete with references to the "macroeconomic purposes" of margin legislation. But courts rarely inquire further into the nature of the asserted connection between the margin requirements and the nation's economic well-being. Indeed, even the experts disagree as to the character of the harms that unbridled margin lending would inflict upon the economy. Without a more particularized understanding of the policies underlying section 7, courts cannot make the delicate judgments necessary to implement an enforcement-based analysis. Hence, any judicial assessment of the need for private enforcement under section 7 seems inherently unreliable.

Before *Ash* and *Chris-Craft*, infatuation with the enforcement rationale led many courts to disregard their limited competency to imply civil liability in margin suits. Whether the Supreme Court's recent decisions will enhance the lower courts' awareness of their shortcomings in this area remains to be seen.