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Statement of Editorial Policy

The Editors

We created the *Villanova Journal of Law and Investment Management* to meet an unmet need. The legal literature lacks a law review devoted to sophisticated discussion of the law of investment management, an area of the law growing exponentially with the industry to which it applies. General law reviews, including business or securities law journals, publish little in the field, and not much of interest to the specialist. We intend the *Journal* to provide a much needed outlet for specialized scholarship in the law of investment management and, by providing a dedicated forum, to stimulate new and challenging scholarship.

Such scholarship is needed badly. The extraordinary growth of the investment industry, the volatility of financial markets and the constant evolution of new market structures has triggered the constant evolution of legal structures. Practitioners, regulators and academics alike struggle not only to keep up with that evolution, but to shape it. We hope that the *Journal* will help those working in the field both understand and lead the ongoing legal transformation.

To that end, we plan to publish articles focusing primarily on the law of investment companies and investment advisers. Of particular interest will be articles on topics under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, relevant aspects of the Securities Act of 1933, the Securities Exchange Act of 1934, and the rules of the self-regulatory organizations. Of similar interest will be work on the relevant portions of the state securities, corporations, trust and partnership laws. In addition, we will publish articles on issues under the federal tax laws and ERISA related to investment companies and investment advisers. The *Journal* also encourages the submission of work on legal aspects of specialized investment vehicles such as real estate investment trusts (REITs).

We read the term "investment management" broadly, and will consider publishing articles on problems in broker-dealer law and regulation and, more generally, articles on securities law topics that may be of interest to our audience.

We intend the articles we publish to be "useful," but they may be useful in a variety of senses. Our articles may help practitioners solve actual problems already on their desks. They may analyze and evaluate the practical impact of recent changes in the law. They may also identify practical or policy problems that call out for law reform. Articles published in the *Journal* may even crystallize possible solutions to fundamental problems of law and policy. To achieve these goals, the articles we publish may employ traditional doctrinal analysis, policy analysis, empirical analysis or other methodologies.

The *Villanova Journal of Law and Investment Management* is an independent, academic publication of Villanova University School of Law. It is dedicated to providing an open forum for writers working from all perspectives, from both sides of the regulatory fence and from all sectors of the industry, the government, the bar and the academy. We encourage the submission of articles that take strong or controversial positions, so long as they are well-researched, well-supported and fairly argued. Some of what you may read in the *Journal*'s pages may provoke you. If so, we invite you to pick up your pen (or boot up your laptop) and write a responding article. We are confident that the collision of different views will yield a deeper understanding of the law of investment management.

THE PAST AND FUTURE OF IMPLIED CAUSES OF ACTION UNDER THE INVESTMENT COMPANY ACT OF 1940

Arthur S. Gabinet
George M. Gowen III[1]

In 1940, Congress enacted the Investment Company Act, a largely regulatory statute governing a growing industry of certain "investment companies," better known as mutual funds.[2] Unlike other SEC-administered statutes, the Act provided no express private cause of action, but the federal courts soon began allowing suits under the Act by private investors, finding that such rights of action were "implied" in the Act. This pattern went largely unchecked -- and relatively unchallenged -- until recent years; the recognition of implied private rights of action even survived Congress' addition of an express right of action under Section 36(b) of the Act in 1970. Recent years have witnessed a slightly more energetic debate over the issue, however, guided by a trend in the United States Supreme Court against judicial liberalist tendencies, including the inference and expansion of private rights under federal statutes. The Court's 1995 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[3] directly criticizing the analytical methods most of the lower courts have used to infer actions under the Act, sharpened the debate.

The Second Circuit Court of Appeals has now pushed the debate over private suits under the Act to the forefront of the judicial landscape. In March 2002, in *Olmsted v. Pruco Life Insurance Company,*[4] the Second Circuit -- historically a venerable champion of the private right of action under the Act -- held that no private cause of action could be inferred for violations of Sections 26(f) and 27(i) of the Act. Although these sections were enacted within the last decade, the court's analysis -- a "back to the basics" adherence to the statutory text -- would logically apply to other, older sections of the Act, including those under which the Second Circuit has upheld private rights of action in the past. The court took specific steps, however, to leave its earlier decisions intact. As if this recent shift would not alone provoke sufficient debate, in February 2000, shortly before deciding *Olmsted*, the Second Circuit handed down a decision, *Strougo v. Bassini*,[5] in which it allowed a private class action to proceed under Sections 36(a) and 48 of the Act, despite its explicit recognition that Congress had not provided for private suits.

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[2] 15 U.S.C. §§ 80a-1 *et seq.* The Investment Company Act is often referred to as the "1940 Act," even though Congress enacted the Investment Advisers Act that same year.

[3] 511 U.S. 164 (1994) (5-4 decision).

[4] 283 F.3d 429 (2d Cir. 2002).

[5] 282 F. 3d 162 (2d Cir. 2002).

The Second Circuit's decisions set the stage for this issue to come before the Supreme Court. In anticipation of the Court's ultimate disposition, this article attempts to provide an historical analysis of the recognition of implied causes of action under the Act. Part I addresses the Act itself and implied causes of action under the Act before *Central Bank*. Part II is an analysis of the relevant portions of the *Central Bank* decision, and Part III reviews the impact of *Central Bank*. Part IV is an in-depth view of the recent sharpening of the debate in the Second Circuit.

I. THE DEVELOPMENT OF IMPLIED CAUSES OF ACTION UNDER THE 1940 ACT

A. THE ORIGINAL 1940 ACT AND THE RECOGNITION OF IMPLIED CAUSES OF ACTION

The 1940 Act arose out of a sweeping reform of corporate and securities law provoked by the economic and political events of the 1920s and the 1930s. Between 1933 and 1940, Congress enacted six of the seven statutes currently administered by the Securities and Exchange Commission: the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.[6] Unlike the 1933 and 1934 Acts, which Congress designed mainly to foster disclosure,[7] Congress designed the 1940 Act to regulate thoroughly an industry in apparent need of supervision.[8]

The "investment companies" governed by the Act included issuers of securities that engage primarily in the investment in other securities, such as mutual funds.[9] By their nature, these institutions, the managers of which have vast quantities of liquid and transferable assets at their disposal, present ample opportunity for mismanagement and abuse.[10] The Act imposed certain safeguards in the industry, such as the requirement of a minimum proportion of disinterested directors on the board of a registered investment company,[11] and the requirement that a majority of these directors approve contracts for adviser services.[12] Unlike each of the

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[6] *See* 1 Louis Loss & Joel Seligman, SECURITIES REGULATION 166-223, 224 (3d ed. 1989).

[7] The 1933 and 1934 Acts "embrace[d] a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (internal quotation marks omitted).

[8] 1 Loss & Seligman, *supra* note 6, at 242; 15 U.S.C. § 78b (1997); 15 U.S.C. § 79a (1997); 15 U.S.C. § 80a-1(a)(5) (1997); 15 U.S.C. § 80a-1(b) (1997).

[9] 15 U.S.C. § 80a-3(a)(1) (1997).

[10] 1 Loss & Seligman, supra note 6, at 242, 247. At Congress's command, the SEC conducted a four-year investigation of the industry. Congress expressly crafted the 1940 Act from the findings of this investigation and, through the 1940 Act, announced its policy to curb abuse through registration requirements and regulation. 15 U.S.C. § 80a-1 (1997).

[11] 15 U.S.C. § 80a-10(a) (1997).

[12] 15 U.S.C. § 80a-15(c) (1997).

securities acts preceding it (the 1933 Act, the 1934 Act, the Public Utility Holding Company Act, and the Trust Indenture Act),[13] the original 1940 Act did not contain any express provision for private civil actions. The Act contained remedial measures, such as authorizations of the SEC to bring actions for violations of certain of its provisions, but not the private causes of action such as those found, for instance, in section 12 of the 1933 Act and section 16(b) of the 1934 Act.

Seemingly contemporaneously with the growth of mutual funds in the 1950s and 1960's,[14] however, the federal courts began recognizing implied rights of action to remedy violations of certain provisions of the Act.[15] The courts' effective recognition often resulted from mere assumption or concession, rather than actual adjudication.[16] The courts did affirmatively decide the issue, but often upon unsatisfactory analysis. For example, in 1963, in *Taussig v. Wellington Fund, Inc.*,[17] the Third Circuit held that stockholder-plaintiffs could pursue a private remedy on behalf of a fund under section 35(d) of the Act, which proscribes the use by funds of titles or names determined to be misleading by the SEC.[18] The court's analysis, however, was almost admittedly lacking.[19] Ultimately, the court recognized the competing

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[13] *See, e.g.*, 15 U.S.C. § 77(k)(a) (1997); 15 U.S.C. 78i(e) (1997); 15 U.S.C. § 79p (1997); 15 U.S.C. § 77www (1997)

[14] James N. Benedict, Mary K. Dulka, & C. Neil Gray, *Recent Developments in Litigation under the Investment Company Act of 1940*, 1250 PLI/CORP. 643, 649 (2001).

[15] "During the period 1959-62 some two dozen of the largest open-end investment companies, together with their directors and 18 investment advisers, were involved in over 50 lawsuits centering largely, but not entirely, around allegations of grossly excessive management or advisory fees." IX Louis Loss & Joel Seligman, SECURITIES REGULATION 4449 n.597 (3d ed. 1989).

[16] For example, in *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961), the majority of a Second Circuit panel affirmed a district court's ruling that the allegations of mutual fund shareholders sufficiently stated violations of §§ 15(a) and (b) (contracts of advisers and underwriters) and § 37 (larceny and embezzlement) of the Act. 294 F.2d at 420-21. A concurring opinion, however, noted that, regrettably, the more important threshold issue of the existence of an implied private cause of action for these alleged violations had been conceded by the defendants. *Id.* at 422 (Clark, J., concurring). In *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964), the First Circuit decided that strict application of state law demand requirements to a derivative suit brought under the Act would conflict with the goals of the Act. *Id.* at 819. The court assumed, however, without comment, and without even noting the particular section of the Act at issue, that the Act gave rise to such an implied right of action in the first place. *Id.*

[17] 313 F.2d 472 (3d Cir. 1963).

[18] 15 U.S.C. § 80a-34(d) (1997).

[19] First, as was astutely pointed out in a dissenting opinion, § 35(d) prohibits only the use of names found misleading by the SEC, suggesting that civil enforcement should occur exclusively through, or should at least be preceded by, an SEC determination. *Taussig*, 313 F.2d at 482 (Smith, J., dissenting). The court cited the jurisdictional section of the Act, which bestows on the federal courts jurisdiction of "all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of the Act," 15 U.S.C. § 80a-43 (1997), as its only legislative authority for its decision, noting that while the Act did not expressly grant any private cause of action, this section "seems to provide a forum for such

positions on the issue of whether a private right can be derived from the Act, and it simply chose the position that a right could be so inferred, for no other apparent reasons than that this position was "not frivolous," that it was not expressly proscribed by Supreme Court law, and that other courts had adopted it in interpreting the 1934 Act.[20]

B. The 1970 Amendments

In a key event in the history of implied causes of action under the Act,[21] in 1970 Congress amended the 1940 Act to add section 36(b): an express right of action for the violation of fiduciary duties. A Senate Committee found that "mutual funds, with rare exception," are operated not by their own employees, but by separate organizations known as "investment advisers."[22] "The[se] advisers select the funds' investments and operate their businesses" and in return are paid fees, often calculated as a percentage of the funds' net assets.[23] The committee found that this unique structure is different than the normal relationship between buyers and sellers of services, as the funds' dependence on the advisers practically prevented the funds from

suits." *Taussig*, 313 F.2d at 476. The court did not note that this jurisdictional statement is substantially similar to the counterpart provisions in other SEC statutes that do expressly provide for private causes of action, such as § 78aa of the 1934 Exchange Act..

[20] *Id.* Each of these three reasons, however, would apply equally to support a decision that no implied right of action existed. In 1961, in *Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), *vacated as moot by agreement*, 369 U.S. 424 (1962), the Eighth Circuit, noting that it would find an implied right of action only to "implement a manifest legislative intent," *id.* at 912, held that the 1940 Act did not by implication create a private cause of action against directors of funds. *Id.* A few years later, however, the court called its own decision into question in *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967). There, the court stated that, in light of the Supreme Court's holding in *J.I. Case Co. v. Borak,* 377 U.S. 426 (1964), that § 14(a) of the 1934 Act implicitly gave rise to private civil remedies, and its directive to the federal courts "to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded," *Borak*, 377 U.S. at 433, it should "reexamine" its holding in *Brouk*. *McLendon*, 378 F.2d at 793. In *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir. 1968), the court found that "although the Investment Company Act makes no specific provision for private civil liability arising from the violations of the Act," private rights of action "may be implied." 402 F.2d at 103. The court's only analysis, however, was its brief notation of an apparent "strong indication" to find private civil liability under federal statutes announced in *Borak*. *Id.*

[21] Mutual funds had grown during the 1950's and 1960's. As a result, investment advisers to the funds, which often earned a fee based on a fixed percentage of the particular fund's assets, had begun to earn increasingly large fees. SEC, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966); *see generally* Benedict, *et al.*, *Recent Developments*, *supra* note 14, at 648. In a 1966 report to Congress, the SEC noted that, among other problems in the industry, these fixed-percentage fees failed to recognize the economies of scale present in managing large funds. SEC, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966); *see generally* Benedict, *et al.*, *Recent Developments*, *supra* note 14, at 648.

[22] S. Rep. 91-184.

[23] *Id.*

severing the relationship. Thus, found the committee, "the forces of arm's-length bargaining" present "in other sectors of the American economy" are not present in the mutual fund industry.[24] To address this concern, Congress added section 36(b), which imposed a fiduciary duty on the investment advisers of registered funds "with respect to the receipt of compensation for services," *and* which expressly provided a cause of action, not only to the SEC but to shareholders of registered funds, for breach of this duty.[25] Thus, the Act, which once did not expressly provide for a private cause of action to enforce *any* of its provisions, now expressly authorized private citizens to enforce one, *but only one*, of its provisions. On the other hand, Congress, while making substantial amendments to the Act, had not expressly overruled the implied rights of action recognized by the courts since the Act's inception. In fact, the Senate Report expressly cautioned that the fact that subsection (b) specifically provides for a private right of action "should not be read by implication to affect subsection (a)."[26]

While the addition of section 36(b) suggested to some that implied rights of action should no longer be recognized, the effect of the 1970 Amendments on the recognition of implied causes of action by the federal courts, if anything, was liberalizing.[27] The courts not only rejected the argument that the amendment adding section 36(b) indicated Congressional intent that courts not allow private suits under any other provisions, but they embraced the 1970 Amendments, which left the federal courts' pattern of recognizing implied rights of action intact, as further evidence that Congress approved of such recognition. For example, in *Tannenbaum v.*

[24] *Id.*

[25] 15 U.S.C. § 80a-35(b) (1997). Bolstering subsequent arguments that Congress "knew how" to create a cause of action when it "wanted to," Congress set forth the parameters of the cause of action. The plaintiff would bear the burden of proving a breach of fiduciary duty. 15 U.S.C. § 80a-35(b)(1). Damages would be limited to the actual damage suffered through the breach and could not exceed the total compensation received by the defendant. 15 U.S.C. § 80a-35(b)(3). Damages would also be limited to those incurred within one year of the institution of the action. 15 U.S.C. § 80a-35(b)(3). Jurisdiction would lie exclusively with the federal district courts of the United States. 15 U.S.C. § 80a-35(b)(5).

[26] S. Rep. 91-184; *see also* H. Rep. No. 91-1382, 91st Cong. 2d Sess. 38 (1970).

[27] Just after the 1970 Amendments, in 1971, the First Circuit decided *Moses v. Burgin*, 445 F.2d 369 (1971), a case involving allegations of an investment adviser's failure to recapture brokerage commissions paid by its mutual fund client. The court confirmed its authority to grant civil recovery for acts falling within the proscription of "gross misconduct or gross abuse of trust" contained in the pre-amendment § 36, glossing over in a footnote the fact that the recent amendments had removed this language. 445 F.2d at 373 & n.7. The amendment substituted the phrase, "breach of fiduciary duty involving personal misconduct" for the removed language. The House Committee Report set forth an explanation of this language: "In appropriate cases, non-feasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." *See* Report of the Committee on Interstate and Foreign Commerce, H. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970). In 1975, in *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975) ("*Fogel I*"), the Second Circuit followed *Moses* and assumed the existence of private liability for breach of fiduciary duty with respect to the recapture of brokerage fees; the parties did not contest the issue. *See Fogel v. Chestnutt*, 668 F.2d 100, 105 (2d Cir. 1981).

Zeller,[28] a case involving allegations of an investment adviser's failure to recapture brokerage commissions paid by its mutual fund client, the Second Circuit noted that the original form of section 36 expressly authorized SEC injunction actions and implicitly authorized private actions. The court rejected the argument that Congress' addition of an explicit right of action with respect to compensation was intended to abrogate the private actions already recognized by the courts for other types of breach of fiduciary duty.[29]

In 1981, in *Fogel v. Chestnutt* ("*Fogel II*"),[30] the appellants argued that Supreme Court authority decided after *Fogel I* rendered the court's and the parties' assumption of the availability of private recovery in *Fogel I* incorrect.[31] The appellants argued that *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), in which the Supreme Court held that the Investment Advisers Act of 1940 did not imply a private cause of action for damages, changed the landscape.[32] The court rejected this argument, noting that *Transamerica* did allow a private suit in equity under the Advisers Act, and the jurisdictional grant in the Advisers Act, originally drafted as identical to that in the Investment Company Act, was changed prior to enactment to provide jurisdiction for only "suits in equity" and not "actions at law."[33] The court again rejected the notion that the addition of the cause of action in section 36(b) abrogated the existing implied causes of action, noting that, rather, the fact that the Investment Company Act had been overhauled after these rights of action had been recognized suggests Congressional approval.[34]

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[28] 552 F.2d 402 (2d Cir. 1977).

[29] 552 F.2d at 416-17.

[30] 668 F.2d 100 (2d Cir. 1981).

[31] 668 F.2d at 105.

[32] *Id.* at 109. The appellants also cited *Cort v. Ash*, 422 U.S. 66 (1975). In *Cort*, the Supreme Court transformed the test for the availability of private rights of action from the simple question of whether the plaintiff was a member of a special class for whose benefit the statute was enacted, to a more rigid, four-factor analysis of the actual words and intent of Congress. *See Cort*, 422 U.S. at 78 (noting the following factors: 1) whether the plaintiff is a member of the class for whose benefit the statute was enacted; 2) whether there is any explicit or implicit indication of Congressional intent to create or withhold private remedies; 3) whether the availability of private recovery would be consistent with the purposes of the statute; and 4) whether the contemplated private cause of action is one conventionally relegated to state law). In later years, the Court further refined the *Cort* test, stating that legislative intent is the most important factor, while the others are supplementary. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 575-76 (1979) (holding that not all the *Cort* factors should be weighted equally and that the main inquiry is congressional intent). The *Fogel II* court noted that the appellants had cited *Cort v. Ash* and *Touche Ross*, but it commented only on *Transamerica. Id.* at 109-12.

[33] Fogel II, 668 F. 2d at 109.

[34] *Id.* at 111-12. In 1990, as part of the Securities Law Enforcement Remedies Act of 1990, Congress added the "actions at law" language to the jurisdictional grant in the Advisors Act, the absence of which proved so important to the *Transamerica* Court. The legislative history surrounding the 1990 amendment

C. THE 1980 HOUSE REPORT

A House Committee Report that accompanied additional amendments to the Act in 1980, through the Small Business Investment Incentive Act of 1980, provided additional, retrospective support for the courts that had decided that finding implied rights of action under the Act should continue after the 1970 Amendments.

> The rationale for implying rights of action under the securities laws beyond those actions expressly provided for had been well articulated by the Supreme Court when it observed that implied private rights of actions allowing shareholders to sue to remedy their losses would significantly assist the congressional goal of promoting fair corporate suffrage. But in recent years, the Supreme Court turned its focus toward a strict construction of statutory language and expressed intent.
>
> The Committee wishes to make plain that it expects the courts to imply private rights of action under this legislation, where the plaintiff falls within the class of person protected by the statutory provision in question. Such a right would be consistent with and further Congress' intent in enacting that provision, and where such actions would not improperly occupy an area traditionally the concern of state law. In appropriate instances, for example, breaches of fiduciary duty involving personal misconduct should be remedied under Section 36(a) of the Investment Company Act. With respect to the business development companies, the Committee contemplates suits by shareholders as well as by the Commission, since these are the persons the provision is designed to protect, and such private rights of action will assist in carrying out the remedial purposes of Section 36.[35]

In *Bancroft Convertible Fund v. Zico Investment Holdings, Inc.*,[36] the Third Circuit opined that "[c]learly, the Committee Report expressly approves the position of those courts which, following the 1970 amendments, held that private causes of action should be implied from the Investment Company Act."[37] The court held that a private right of action existed under

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does not suggest that the addition of this language represents congressional intent to create a private right of action for damages under the Advisers Act.

[35] H.R. Rep. No. 1341, 96th Cong., 2d Sess., 28-29 (1980). The 1980 enactment added a number of new provisions to the Act, giving special treatment to certain business development companies and, in effect, amending existing provisions of the Act. Thus, the statements in the House Committee Report were only partially retrospective.

[36] 825 F.2d 731 (3d Cir. 1987).

[37] 825 F.2d at 736.

section 12(d)(1)(A) of the Act, which prohibits the acquisition by an investment company of more than three percent of the outstanding stock of another investment company.[38]

II. CENTRAL BANK

In 1994, however, the Supreme Court cast considerable doubt on the statutory interpretive principles that supported the decisions of those courts that had recognized private rights of action under the Act. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[39] was not about the Investment Company Act, but rather the scope of the implied private right of action under section 10(b) of the 1934 Act.[40] The Court had granted *certiorari* to resolve confusion among the lower courts about the viability of private liability for section 10(b) aiding and abetting in light of the Court's recent strict interpretations of the securities laws in *Santa Fe Industries, Inc. v. Green*[41] and *Ernst & Ernst v. Hochfelder*.[42] The Court noted that, in defining the scope of a statutory prohibition, it must adhere strictly to the statutory text, and it would not allow a private section 10(b) suit for conduct not prohibited by the text of the statute.[43] Noting that the text also did not mention aiding and abetting, the Court rejected the SEC's argument that the phrase "directly or indirectly" in the text of the statute indicated coverage of aiding and

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[38] *Id.* at 733, 736. Other courts held similarly. *See, e.g.*, *In re ML-LEE Acquisition Fund II, L.P. & ML-LEE Acquisition Fund (Retirement Accounts) II, L.P. Sec. Litig.*, 848 F. Supp. 527, 538-49 (D. Del. 1994) (finding implied rights of action under §§ 17(j), 36(a), and 57(a), (d)); *Lessler v. Little*, 857 F.2d 866, 873 (1st Cir. 1988) (recognizing private cause of action under section 17(a)(2) of the Investment Company Act); *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981) (recognizing implied rights of action for damages under section 36(a) of Investment Company Act where advisers or directors breach fiduciary duty); *Meyer v. Oppenheimer Management Corp.* 764 F.2d 76, 86-88 (2d Cir. 1985) (recognizing implied private right of action under section 15(f) of Investment Company Act); *Krome v. Merrill Lynch & Co.*, 637 F. Supp. 910 (recognizing implied private rights of action under sections 10(b), 15(a-b), 17(a), 22, 34(a), and 36 of the Investment Company Act), *vacated in part*, 110 F.R.D. 693 (S.D.N.Y. 1986); *Jerozal v. Cash Reserve Management, Inc.*, No. 81 Civ. 1569, 1982 WL 1363, at *4-5 (S.D.N.Y. August 10, 1982) (recognizing implied private rights of action under sections 15, 35(b), 47(a) of the Investment Company Act); *Cambridge Fund, Inc. v. Abella*, 501 F. Supp. 598, 622-23 (S.D.N.Y. 1980) (implying private right of action under 36(a) and 37 of the Investment Company Act). *But see Potomac Capital Markets Corp. v. Prudential-Bache Corp. Dividend Fund, Inc.*, 726 F. Supp. 87, 92-94 (S.D.N.Y. 1999) (denying rights of action under §§ 13(a)(4), 25(a), although recognizing private right to enforce § 13(a)(3); *M.J. Whitman & Co. v. American Fin. Enter., Inc.*, 552 F. Supp. 17, 22 (S.D. Ohio 1982) (holding that no general private right of action existed against company's failing to register under the Act), *aff'd*, 725 F.2d 394 (6th Cir. 1984).

[39] 511 U.S. 164 (1994) (5-4 decision).

[40] *Id.* at 165-67.

[41] 430 U.S. 462 (1977). *See id.* at 473 (holding that § 10(b) does not prohibit breaches of fiduciary duty without misrepresentation or lack of disclosure).

[42] 425 U.S. 185 (1976). *See id.* at 199 (holding that § 10(b) does not reach negligent conduct).

[43] *Central Bank*, 511 U.S. at 173.

abetting,[44] as "Congress knew how to impose aiding and abetting liability when it chose to do so."[45]

The *Central Bank* Court went on, however, in *dicta*, assuming *arguendo* that it needed to look beyond the text of the statute to determine its scope, to opine on "'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.'"[46] In so doing, the Court addressed arguments concerning congressional intent. The Court rejected the argument that references to aiding and abetting liability under section 10(b) in 1983 and 1988 Committee Reports demonstrated congressional intent that 10(b) prohibits aiding and abetting: "We have observed on more than one occasion that the interpretation given by one Congress (or a committee or member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute."[47] The Court also cast doubt on the strength of the "acquiescence" doctrine as an indicator of congressional intent, noting that the mere fact that Congress had amended the 1934 Act after the courts first began recognizing a private section 10(b) remedy for aiding and abetting did not represent affirmative congressional approval of the statutory precedents.[48] Similarly, in addressing an argument about rejected additions to the 1934 Act that would have expressly outlawed aiding or abetting a violation of the Act, the Court noted that "failed legislative proposals" are shaky ground on which to rest statutory interpretation.[49]

Thus, the Court, either wittingly or unwittingly, clearly rejected the interpretive principles upholding decisions such as *Tannenbaum*, *Fogel II*, and *Bancroft*. As was noted by the *Central Bank* Court, however, its task -- to determine the scope of the prohibitions of a statute -- was more limited than that before those courts -- to determine whether to recognize an implied right of action at all.[50] The Court expressly distinguished the two questions: "With [respect] to the first issue, the scope of conduct prohibited by section 10(b), [as opposed to the question of the existence of a private right of action under section 10(b)], the text of the statute controls our decision."[51] The Court did not explain why congressional silence would control the question of the scope of the prohibitions of a statute, but not the question of who may enforce those prohibitions, but, nonetheless, it carefully drew that distinction before rendering its opinion.

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[44] *Id.* at 175-76.

[45] *Id.* at 176.

[46] *Id.* at 178 (quoting *Musick, Peeler & Garret v. Employers Ins.*, 508 U.S. 286, 294 (1993)).

[47] *Public Employees Retirement Sys. v. Betts*, 492 U.S. 158, 168 (1989) (*quoted in Central Bank*, 511 U.S. at 185-86).

[48] *Central Bank*, 511 U.S. at 186.

[49] *Id.* at 187.

[50] *See id.* at 172-73 (noting the distinction between determining the scope of conduct prohibited by § 10(b) and deciding elements of an implied private liability scheme).

[51] *Id.* at 173.

Thus, the rationale of the *Central Bank* holding does not ultimately control the question of implied rights of action under the 1940 Act. Some commentators have overreacted to the *Central Bank* decision and opined that it does, but that is inaccurate.[52] In particular, the *Central Bank* Court's comment, "Congress knew how to impose aiding and abetting liability when it chose to do so,"[53] has been taken out of context to suggest that Congress also knew how to create a private right of action when it chose to do so. Because the *Central Bank* Court was determining the scope of implied rights of action under section 10(b), however, implicit in its holding was the recognition that Congress may not always "know how" to create a right of action when it "wants to," and often leaves that task to the courts.

III. IMPLIED RIGHTS OF ACTION UNDER THE 1940 ACT AFTER *CENTRAL BANK*

Central Bank did not deter federal courts from interpreting the Act to provide private remedies. In *Krouner v. American Heritage Fund, Inc.*,[54] the court dismissed claims brought under section 8(b)(3) and (5) of the Act, which governs the required disclosures in a registration statement, and under section 13(a)(3), which governs deviation from investment policies.[55] This was only because the complaint failed to state a violation of either section, however, and not because of any doubt over the existence of a private cause of action for such a violation. In fact, the court did not differentiate between these claims and the plaintiff's claim under section 36(b). In *Langner v. Brown*,[56] another court of the Southern District of New York addressed the issue, but it relied directly on interpretive tools rejected by *Central Bank*. The court did not cite *Central Bank* and, constrained by the holding of *Fogel II* (the rationale of which was called into question by, but which was technically left intact by, *Central Bank*), held that the only question was whether the plaintiffs fell within the class of persons the particular section of the Act was designed to protect.[57] In 1996, in *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*,[58] the court cited *Central Bank*, but only for the proposition that its analysis must begin with the text of the statute.[59] The court went on to hold that sections 47 and 44, which provide, respectively, that

[52] Some commentators have reported, inaccurately, that "Central Bank plainly instructs that absent express statutory language providing citizens a private right of action, federal courts should decline to imply one." *See, e.g.*, Benedict, *et al.*, *Recent Developments*, *supra* note 14, at 665-66. To the contrary, *Central Bank* interpreted the scope of conduct reachable *through an implied right of action under § 10(b).* The decision simply cannot be construed as "signal[ing] a strong presumption against implying rights of action under the federal securities laws." *Id.* at 665.

[53] *Central Bank*, 511 U.S. at 176.

[54] 899 F. Supp. 142 (S.D.N.Y. 1995).

[55] *Id.* at 148-49.

[56] 913 F. Supp. 260 (S.D.N.Y. 1996).

[57] *Id.* at 268.

[58] 916 F. Supp. 1343 (D.N.J. 1996).

[59] *Id.* at 1349.

contracts in violation of the Act are unenforceable and rescindable and that federal courts have jurisdiction over suits at law and equity under the Act, sufficiently evidenced congressional intent to provide a private remedy under sections such as section 7 of the Act.[60] Other district courts decided cases presenting implied rights of action under the 1940 Act without any discussion of the issue at all, let alone comment on the impact of *Central Bank*.[61]

The first decision to deal head on with the teachings of *Central Bank* was *In re Nuveen Fund Litigation*, in which the court recognized private causes of action under sections 34(b) and 36(a) of the 1940 Act.[62] First distinguishing *Transamerica*, the court stated that the subsequent legislative history of the Act and the fact that Congress had not yet commented on or prohibited implied rights of action were indicators of congressional intent to allow private remedies.[63] The court rejected the defendants' argument that *Central Bank* rendered this reasoning unsupportable, but in doing so, it simply relied on the type of evidence of congressional intent rejected by *Central Bank*: the 1980 House Committee report expressing the expectation that courts will recognize implied rights of action.[64] The *Nuveen* court stated that this report carried weight despite *Central Bank*, because the subsequent congressional reports at issue in *Central Bank* contained, as the *Central Bank* Court noted, only "oblique" references to aiding and abetting liability, while the 1980 House report expressly encouraged private rights of action under the 1940 Act.[65] This misinterpretation of *Central Bank* appears almost forced; quite clearly, the *Central Bank* Court's criticism was that the reports represented the thoughts of *one committee* of a *subsequent* Congress, not that the language in the reports was insufficiently direct[66] -- a criticism that applies equally to the 1980 House report. In fact, the only indicator of congressional intent cited by *Nuveen* that may survive *Central Bank*'s criticism is the Senate Report accompanying the addition of section 36(b) in 1970, cautioning against any inference that

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[60] *Id.* at 1349-50.

[61] In *Sheppard v. TCW/DW Term Trust 2000*, 938 F. Supp. 171 (S.D.N.Y. 1996), the court avoided the issue of whether § 13(a)(3) provided for private recovery by finding that the complaint failed to state a violation of the section. *See id.* at 180 n.7 ("Having found that plaintiffs fail to allege that the Trusts deviated from their fundamental policies, the Court need not address the disputed issue of whether Section 13(a)(3) of the 1940 Act provides a private right of action."). In *In re Alliance North American Government Income Trust, Inc. Securities Litigation*, No. 95 Civ. 0330 (LMM), 1996 WL 551732 (S.D.N.Y. Sept. 27, 1996), the court decided a motion to dismiss claims under the §§ 13(a)(3), 34(b), 35(d) and 48 of the Act, without any discussion about whether private recovery under those sections was even available. *Id.* at *3-9. Apparently, the parties did not raise the issue, and the court did not see a need to raise it *sua sponte*.

[62] No. 94 C 360, 1996 WL 328006 (N.D. Ill. June 11, 1996).

[63] *Id.*, 1996 WL 328006, at * 5.

[64] *Id.* at *5.

[65] *Nuveen*, 1996 WL 328006, at *6.

[66] *Central Bank*, 511 U.S. at 185.

the new cause of action changed the state of the law with respect to section 36(a).[67] That report, however, speaks to contemporary congressional intentions only for section 36(b). It does not support the *Nuveen* court's holding that section 34(b) provides a private right of action, and it does not speak to the intentions of the 1940 Congress that enacted section 36(a).[68]

In *Strougo v. Scudder, Stevens & Clark, Inc.*,[69] a court in the Southern District of New York followed suit, citing *Nuveen* and holding that section 36(a) implied a private right of action, despite *Central Bank*. The court noted that the cameral reports that stated that the addition of section 36(b) did not affect section 36(a), but the court also went on to cite the statements in the 1980 House Committee Report, despite its own recognition that an important factor in determining an implied right of action is "the *contemporary* legal context in which Congress acted."[70] *Strougo* does not deserve the extent of the criticism it has received; it certainly is not guilty of ignoring any "marked aversion toward implied rights" shown in *Central Bank*,[71] as *Central Bank*, defining the conduct reachable through an implied right of action under section 10(b), displayed no such aversion. *Strougo*, however, like *Nuveen*, resonates with an inconsistency on the treatment of congressional silence and inaction. According to its logic, where Congress does not expressly overrule court action, it has approved it. Where Congress has enacted a private cause of action for some sections but has not for others, however, the courts acknowledge nothing implicit in this silence.[72]

It was not until 1997 that a court, the Seventh Circuit, signaled at least a recognition that *Central Bank* had undermined the analysis that supported earlier decisions to recognize implied rights of action under the 1940 Act. In *Boland v. Engle*,[73] the court stated, in a footnote, that *Central Bank* "cast doubt on the type of analysis that courts have used to find implied rights of action," but that "fortunately [we] need not enter this debate because . . . we find that . . .

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[67] *Nuveen*, 1996 WL 328006, at *6.

[68] Of course, one must consider the role of the fundamental doctrine of *stare decisis* in the analysis of the *Nuveen* and other courts. At least with respect to § 36(a), the *Nuveen* court could have relied on prior decisions recognizing causes of action and limited its search for congressional intent to any recent/subs. intent to overrule those decisions. The court went further, however, and interpreted the 1970 Congress's actions as acceptance of the entire state of judicial recognition of private recovery under the Act. *See Nuveen*, 1996 WL 328006, at *6.

[69] 964 F. Supp. 783 (S.D.N.Y. 1997).

[70] *Id.* at 796-97, & n.3 (emphasis added).

[71] Benedict, *et al.*, *Recent Developments*, *supra* note 14, at 670.

[72] Of course, the 1970 Congress was not completely "silent" as to the effect of the addition of § 36(b) on the availability of private recovery under § 36(a).

[73] 113 F.3d 706 (7th Cir. 1997).

Boland's ICA claims were properly dismissed for other reasons."[74] Still, subsequent district court decisions assumed or recognized the presence of private rights of action under the Act.[75]

IV. OLMSTED

A. THE DISTRICT COURT'S OPINION

In fact, the first district court to carefully consider and then reject the notion of implied rights of action under the Act, *Olmsted v. Pruco Life Insurance Company of New Jersey*,[76] did not even rely heavily on *Central Bank*. The *Olmsted* court faced the question, of first impression, of whether sections 80a-26(e) (requiring reasonable fees deducted in connection with variable insurance contracts) and 80a-27(i) (requiring compliance with section 80a-26(e) in sale of variable insurance contracts) provided a private cause of action.[77] These sections had been added to the Act by amendments in 1996.[78] Although the court did not cite *Central Bank* at this point in its analysis, it seemed to be acting in reaction to its teachings, as the court answered this question by going back to the basics of statutory interpretation, and avoiding the interpretive principles rejected by in *Central Bank*. The court noted that, since 1975, determining the availability of a private cause of action involved not merely asking whether the plaintiff was a member of a class the statute was designed to protect.[79] Rather, the analysis followed the four-part test announced in *Cort v. Ash*, which had been subsequently tailored to focus especially on legislative intent.[80] Searching for legislative intent, the court held that, given the Act's broad grant of power to the SEC to investigate and bring injunction or penalty actions for violations of the Act, "it is highly improbable that 'Congress absentmindedly forgot to mention an intended private action' as a supplemental enforcement mechanism.'"[81] The court also held that the fact that Congress added the express cause of action in section 36(b) further indicated that when Congress wanted to create a right of action, "it knew how to do so."[82] Having decided the

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[74] *Id.* at 715 n.9.

[75] *See, e.g.*, *Green v. Fund Asset Mgmt., L.P.*, 19 F. Supp. 2d 227, 232 (D.N.J. 1998) (assuming existence of private right of action under § 36(a) of the 1940 Act); *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914, 925 (S.D. Tex. 1998) (holding that § 36(a) implies a private right of action, despite the teachings of *Central Bank*).

[76] 134 F. Supp. 2d 508 (E.D.N.Y. 2000).

[77] *Id.* at 511.

[78] 15 U.S.C. § 80a-26(e) (1997); 15 U.S.C. § 80a-27(i) (1997).

[79] Olmsted, 134 F. Supp. 2d at 512.

[80] *Id.*

[81] *Id.* at 513 (quoting *Cannon v. University of Chicago*, 441 U.S. 677, 742 (1979) (Powell, J., dissenting)).

[82] *Id.*

paramount issue of congressional intent, the court rejected the plaintiffs' argument under another *Cort* factor, that they were members of the class the sections were designed to protect.[83] Citing *Central Bank*, the court also rejected the 1980 House report relied on so heavily by courts in previous decisions.[84] Because sections 80a-26(e) and 80a-27(i) had been added in 1996 to deal specifically with variable insurance contracts, the years of decisions recognizing implied rights of action under the Act did not sway the court.[85]

B. THE SECOND CIRCUIT DECISION

Understandably, the plaintiffs appealed the decision to the Second Circuit -- the court that decided *Tannenbaum*, *Fogel I*, and *Fogel II*. In its March 7, 2002 opinion, the court adopted a markedly different approach than it had in years past, focusing on the seemingly basic and fundamental tenet that had been absent from many prior opinions on the subject: when determining whether Congress intended a cause of action to exist, the most telling indicator is the simple fact that Congress did not do so itself. With this "back-to-the-basics" approach, the court correctly stated that even implied rights of action under federal law do not exist unless it may be determined that Congress actually intended that they exist, "'no matter how desirable that may be as a policy matter, or how compatible with the statute.'"[86] A court must begin the search for the necessary congressional intent with the text of the statute itself and "cannot ordinarily conclude that Congress intended to create a right of action when none was explicitly provided."[87] Because the Act did not explicitly provide for a cause of action under either of the sections at issue in *Olmsted*, the court held that a presumption existed that Congress did *not* intend to create a cause of action.[88] The court reasoned that this fundamental presumption was strengthened by three additional factors. The first was the fact that sections 26(f) and 27(i) do not contain "rights-creating language"; the sections provide only that certain conduct is "unlawful" and reflect no focus on the persons protected.[89] Second, the Act provides the SEC with authority to

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[83] Olmsted, 134 F. Supp. 2d at 515.

[84] *Id.* at 515.

[85] *Id.* at 516.

[86] *Olmsted v. Pruco Life Ins. Co.*, 283 F. 3d 429, 432 (2d Cir. 2002) (quoting *Alexander v. Sandoval*, 532 U.S. 275, 286-87 (2001)). In an *amicus curiae* brief, the SEC declined to adopt a position on the question of the availability of private recovery under §§ 26 (e) and 27 (i). Rather, the SEC argued that the plaintiffs' claims could be adequately addressed through the express remedial scheme available under § 47 (b), which permits recission of and restitution of amounts paid under an unlawful portion of a contract. It is not clear whether the SEC's argument reflects a shift in its position on private enforcement of the Act, or whether it reflects a hope that the court would find a way to affirm without disturbing its earlier, more fundamental decisions.

[87] *Id.*

[88] *Id.*

[89] *Id.* at 432-33.

enforce all its provisions; this express provision of one specific enforcement mechanism indicates congressional intent to preclude others.[90] Third, Congress's provision of the express remedy in section 36(b) for breaches of fiduciary duties also suggested "that omission of an explicit private right to enforce other sections was intentional."[91] With the addition of these three factors, the court concluded that the presumption that Congress did not intend to create a cause of action was "strong."[92]

The court went on to reject each of the plaintiffs' arguments raised to rebut the presumption. The plaintiffs argued that the court should not depart from the long line of cases finding implied rights under the Act.[93] The court stated that "when those cases were decided," the courts were without the restrictions imposed in 1975 by *Cort v. Ash*, or the reference in subsequent decisions, and had "more latitude to weigh statutory policy and other considerations."[94] The court also rejected the plaintiffs' "legal context" argument -- that in enacting sections 26(f) and 27(i), Congress expected and relied on courts to infer causes of action, given their past history of doing so.[95] The court held that context serves only to clarify ambiguous text, and the text of the 1940 Act unambiguously did not provide for a cause of action.[96] The plaintiffs also pointed to the 1980 House Committee Report and to a 1996 House Committee Report accompanying sections 26(f) and 27(i),[97] but the court rejected those sources because "[w]here the text of a statute is unambiguous, 'judicial inquiry is complete[ ] except in rare and exceptional circumstances,'"[98] with "legislative history instructive only upon 'the most extraordinary showing of contrary intentions.'"[99] The 1980 report, which post-dated the Act and

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90 *See id.* at 433 ("'The Express provision of one method enforcing a substantive rule suggests that Congress intended to preclude others . . . . Sometimes the suggestion is so strong that it precludes a finding of congressional intent to create a private right of action, even though other aspects of the statute . . . suggest the contrary.'" (quoting *Sandoval*, 532 U.S. at 290)).

91 Olmsted, 283 F. 3d at 433.

92 *Id.*

93 *Id.* at 433-34.

94 *Id.* at 434. The cases cited by the court in this distinction, however, all were decided after 1975, not to mention the court's own 1977 decision in *Tannenbaum* and its 1981 decision in *Fogel II*.

95 *Id.* at 434-35 .

96 Olmsted, 283 F. 3d at 435.

97 The 1996 House Committee Report states that the new provisions subject variable insurance contracts to the same general prohibitions on excessive fees as mutual funds.

98 Olmsted, 283 F. 3d at 435 (quoting *Garcia v. United States*, 469 U.S. 70, 75 (1985)).

99 *Id.* (quoting *Garcia*, 469 at 75).

pre-dated sections 26(f) and 27(i), did not qualify, and the 1996 report contained no contrary indications as to remedies.[100]

Litigants hoping for a more fundamental and conservative approach to implied causes of action under the Act have no cause for complaint about this decision, but, in a certain light, the *Olmsted* holding is inconclusive and unsatisfying, if for no other reason than its direct contradiction with *Tannenbaum* and *Fogel II*. The critical point in the decision was a fundamental presumption that Congress' failure to provide an express cause of action reflected its intent that no such right of action exist. The reasoning behind this presumption, however, would apply to the entire Act and, thus, to the questions before the court in *Tannenbaum* and *Fogel II*. The court held that this presumption was strengthened by the facts that Congress empowered the SEC to enforce the Act and created section 36(b), but these facts also would apply to the entire Act and, thus, in *Tannenbaum* and *Fogel II*. In fact, in *Tannenbaum*, the court had stated that Congress originally had designed section 36 to expressly authorize SEC enforcement and to imply private damages actions against fiduciaries. Now, in *Olmsted*, the court has stated that Congress's specific grant of authority to the SEC is *inconsistent* with an intent to imply private enforcement authority.

The *Olmsted* court made an attempt to address these inconsistencies. As for the "long line of decisions recognizing implied private rights of action as a way of promoting the policies served by the [1940 Act],"[101] the court stated that those decisions were rendered at a time when courts had more leeway to consider statutory policy, rather than congressional intent.[102] The court correctly noted that in 1975, with *Cort v. Ash*, the Supreme Court changed the inquiry, from the simple question of whether a statute was enacted for the benefit of a particular class, to a multi-factor, structured approach.[103] The court also correctly noted that post-*Cort* decisions further honed the inquiry to focus predominantly on legislative intent.[104] The cases the court was distinguishing, however, were decided *after* 1975.[105] Moreover, *Cort v. Ash* predated the Second Circuit's own decision in *Tannenbaum*, and the subsequent decisions cited by the court as refining *Cort v. Ash*[106] pre-dated its own decision in *Fogel II*. The *Olmsted* court simply did not explain adequately why, if its decision was based on a refraining from considerations of statutory policy, that same restraint was absent from these earlier decisions.

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[100] *Id.*

[101] *Id.* at 433-34.

[102] *Id.* at 434.

[103] Olmsted, 283 F. 3d at 434.

[104] *Id.*

[105] See *id.* at 434 n.4 (citing cases dated form 1985 through 1998).

[106] *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Northwest Airlines, Inc. v. Transportation Workers Union*, 451 U.S. 77 (1981).

In a footnote, the court also specifically addressed the conflict with *Fogel II*, stating that *Fogel II* was simply an "assumption" that, in enacting section 36(b) in 1970, Congress had not overruled prior judicial recognition of implied causes of action.[107] The Court distinguished *Fogel II* from *Olmsted* only on the grounds that *Olmsted* dealt with new sections of the Act, the implicit potential of which could not have been addressed by a court prior to 1970.[108] The court stated "[w]e express no opinion on the current validity of our assumption in *Fogel [II]* because in this case we interpret sections added after Congress created the private right of action in section36(b)."[109] The court had cited the addition of section 36(b), however, as evidence that Congress did not intend to imply rights of action and "'knew how do to so . . . expressly.'"[110] The court seemed to hold that, under its reasoning, causes of action that already had been recognized by 1970 were valid. Surely, however, the court could not be suggesting that Congress only learned "how to do so" between the 1940 legislation and the 1970 amendments. In any event, the court's holdings in *Fogel II* and *Tannenbaum* obviously were not supported solely by a finding that the addition of section 36(b) did not completely overrule prior decisions. Those decisions built on earlier rulings that private rights in fact existed, and those earlier rulings were based on reasoning rejected in *Olmsted*. Thus, even accepting this strained effort to leave *Fogel II* intact, given the fundamental and broad-ranging reasoning supporting the *Olmsted* opinion, it stands in stark contrast to, and seriously undermines, *Tannenbaum* and *Fogel II*.

The inconsistency of the *Olmsted* opinion, or at least the failure of the *Olmsted* court to state expressly that its holding constituted a shift away from opinions like *Tannenbaum* and *Fogel*, is exacerbated by another Second Circuit decision handed down only a week before *Olmsted*. In *Strougo v. Bassini*,[111] the issue was not the existence of private rights under the Act, but rather whether the plaintiffs had individual standing to bring direct claims, as opposed to derivative claims, under sections 36(a), 36(b), and 48 of the Act.[112] In applying Maryland law to that question, however, the court reviewed the policy objectives underlying the 1940 Act to determine whether Maryland shareholder standing law conflicted with those policies.[113] The court held that "the potential availability of direct action" was consistent with the general policies of the Act, and that the plaintiff's allegations supported direct claims under sections 36(a), 36(b), and 48. Like the sections at issue in *Olmsted*, however, section 48 provides only that certain conduct is "unlawful," and section 36(a) provides only that the SEC is authorized to

[107] Olmsted, 283 F. 3d at 434 n.4.

[108] *Id.* at 433 n.3.

[109] *Id.*

[110] *Id.* at 433 (quoting *Touche Ross*, 442 U.S. at 572).

[111] 282 F. 3d 162 (2d Cir. 2002).

[112] *Strougo*, 282 F. 3d at 169.

[113] *Id.* at 174-76.

bring civil actions; neither contains "rights-creating language" as defined by *Olmsted*.[114] The grant of authority to the SEC that, to the *Olmsted* court, evidenced congressional intent against private rights of action applies equally to section 48 and especially to section 36(a), which itself is a specific grant of authority to the SEC.[115] Again, the question of the general availability of private suit under these sections was not technically at issue on appeal in *Strougo*, but one would think that Circuit Judge Sack, who himself would author the *Olmsted* decision one week later, would at least have commented on the issue in *Strougo* before allowing such claims to proceed.

V. CONCLUSION

In its fundamental analysis, and in its result, the *Olmsted* court appears to have gotten it right. The court honed in on a crucial distinction glossed over by courts interpreting the 1940 Act and other statutes for years: the distinction between the term "implied" and the term "inferred." An "implied" private right of action must indeed be implied; it must actually be communicated by Congress, albeit indirectly. Only Congress can "imply" a right of action; for years, despite the commonly-used phrase, courts had not really been "implying" rights of action, but rather "inferring" them, drawing their own conclusions from the evidence or circumstances surrounding actual congressional statements. In fact, as the *Olmsted* court recognized, courts had moved beyond mere inference, which at least centers on Congress's intent, and had begun simply determining whether private rights of action were consistent with the policies and goals of a particular statute. *Olmsted* adhered to the fundamentals, as *Cort v. Ash* had taught: if Congress did not specifically intend the existence of a right of action, no such right could exist. And, as *Central Bank* had taught, courts may not perform intellectual gymnastics or rely on circumstantial evidence to glean congressional intent. In fact, if Congress did not itself create a right of action, and if the presumption that leads from that fact is strengthened by other evidentiary factors, the inquiry essentially should end, absent unique and extraordinary indicators to the contrary.

Constrained by the issue before it, however, the *Olmsted* court could only go so far. The court rested its decision on principles at odds with the principles supporting earlier decisions concerning other sections of the very same act. To the extent it attempted to explain the incongruence, its efforts, inevitably, were unsuccessful. The importance of the 1970 amendments in the *Olmsted* court's limitation of its holding is a stretch, and is inconsistent. As *Central Bank* taught, the addition of section 36(b) meant nothing in terms of congressional intent, other than the fact that that Congress desired to create a specific fiduciary duty with respect to compensation and an express private right of action for breaches of that duty. *Fogel II* was right on this point -- the addition of section 36(b) does not equal congressional overruling of those implied private actions already recognized by the courts. Nor did it evidence congressional acceptance of that practice, however, and more importantly, it evidenced absolutely nothing about the intentions of the *1940 Congress* intentions with respect to private rights under the Act. Even Congress's warning that the addition of section 36(b) did not imply any effect on section

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[114] *Olmsted*, 283 F. 3d at 432; *see* 15 U.S.C. § 80a-35 (a); 15 U.S.C. § 80a-47.

[115] *See Olmsted*, 283 F. 3d at 433; 15 U.S.C. § 80(a)-36(a).

36(a) says only just that: it says nothing about implied rights of action, it means nothing at all about the remainder of the Act, and, even if it were an acceptance of implied rights under the Act, it says nothing about the intentions of the 1940 Congress on that subject.

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MONEY LAUNDERING REQUIREMENTS FOR BROKER-DEALERS AND HEDGE FUNDS UNDER THE USA PATRIOT ACT OF 2001

Marc C. Cozzolino*

I. INTRODUCTION

Broker-dealers[1] have been subject to federal anti-money laundering laws imposing reporting and record keeping requirements since 1970. The USA Patriot Act of 2001 (Patriot Act),[2] however, aimed at giving the government new powers to combat terrorism, dramatically increases the anti-money laundering requirements imposed on financial institutions, and may also force broker-dealers and hedge funds to make many changes in their compliance programs, such as establishing anti-money laundering compliance procedures, verifying the identity of new accounts and filing suspicious activity reports (SARs).

II. BACKGROUND

Prior to the promulgation of the Patriot Act, the primary anti-money laundering rules for broker-dealers were found in the Bank Secrecy Act of 1970[3] (BSA). Under the BSA, broker-dealers that are subsidiaries of bank holding companies are required to report currency transactions in excess of $10,000 on a Currency Transaction Report (CTR).[4] The BSA also requires broker-dealers to file reports relating to the physical transportation of currency or bearer instruments in amounts over $10,000 into or outside of the United States on a Currency or Monetary Instrument Transportation Report (CMIR).[5]

The U.S. Treasury Department (Treasury) has also adopted other record keeping rules, which have varying degrees of relevance to the securities industry. For example, in 1994, the BSA was amended to prohibit financial institutions from selling money orders, or bank, cashier's or traveler's checks for more than $3,000 in currency unless the institution first verifies and records the identity of the purchaser. Although most broker-dealers do not engage in cash transactions and do not sell these types of instruments, these responsibilities are still applicable

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1 The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. *See* 15 U.S.C. § 78c3(a)(4). The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business. *See* 15 U.S.C. § 78c3(a)(5).

2 Pub. L. No. 107-56.

3 31 U.S.C. § 5312(a)(2) (2000).

4 *See id.*

5 *See id.*

to the securities industry. In 1995, Treasury promulgated a "Joint Rule" and a related "Travel Rule" requiring all financial institutions to maintain certain information regarding funds transfers of $3,000 or more,[6] and to include the required information in the transmittal of funds.[7]

Broker-dealers, like other financial institutions, also have been subject to the criminal provisions of the Money Laundering Control Act of 1986 (MLCA) since 1986.[8] Among other things, the MLCA established two anti-money laundering criminal statutes that for the first time, made money laundering a crime in and of itself.[9] The MLCA also added certain provisions to the BSA, which are also applicable to broker-dealers, including a specific prohibition against "structuring" transactions to avoid the impact of the BSA's reporting thresholds.

Broker-dealers that account for the vast majority of customer assets within the securities industry have been filing SARs, either voluntarily or as required pursuant to rules that apply to bank holding company subsidiaries. The SEC and the self-regulatory organizations (SROs) also have various existing regulations requiring the reporting of securities violations in order to ensure the safety and soundness of securities firms, *see, e.g.*, Forms U-4, U-5 and RE-3.

Furthermore, broker-dealers, like other financial institutions, are subject to the sanctions programs administered by the Office of Foreign Assets Control (OFAC).[10] These include prohibitions against trading with certain identified enemies of the United States, as set forth in various lists prepared and updated by OFAC and other government agencies.

Other types of requirements have also long existed at the due diligence stage of transactions, particularly through the application of the “know your customer” concept. That concept has developed in the securities industry largely from the rules of SROs designed to ensure that a recommended securities transaction is suitable for a particular customer. For example, New York Stock Exchange (NYSE) Rule 405 provides that "each member organization is required . . . to . . . [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."[11] The National Association of Securities Dealers’ (NASD) Conduct Rules[12] similarly require securities firms to obtain basic information pertaining to the prospective customer at the time the account is opened, including the customer's name and residence and whether the customer is of

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[6] *See* 31 C.F.R. §§ 103.33(e) & (f) (2000).

[7] *See* 31 C.F.R. §§§ 103.33(e), (f) and (g) (2000).

[8] P.L. No. 99-570, 18 U.S.C. §§ 1956, 1957 (1994 & Supp. 2000).

[9] *See* 18 U.S.C. §§ 1956, 1957 (2000).

[10] *See* <http://www.treas.gov/ofac/>

[11] NYSE Rule 405.

[12] *See* NASD Conduct Rule 2310(a). *See also* Section 11 of the NASD By-Laws and AMEX Office Rule 411. In addition, various SROs impose suitability requirements on broker-dealers.

legal age. Additionally, for certain types of accounts, securities firms must make reasonable efforts to obtain, prior to the settlement of the initial transaction in the account, "the customer's tax identification or Social Security number, occupation of the customer and name and address of employer, and whether the customer is an associated person of another member."[13]

In addition, commodities firms, who may sponsor U.S.-based hedge funds, apply a similar "know your customer" concept. Although the Commodity Exchange Act[14] (CEA) and its rules do not expressly establish the concept, the National Futures Association (NFA) has adopted a "know your customer" rule[15] that requires commodity professionals, including commodity trading advisors (CTAs)[16] and commodity pool operators (CPOs),[17] to obtain information designed to ascertain the identity of the customer and its suitability to trade futures contracts, and to make appropriate risk disclosures to the customer in light of information gained from the customer. For example, the information to be obtained from a customer must include at least the following: (i) the customer's true name, address and principal occupation or business; (ii) the customer's current estimated annual income and net worth; (iii) the customer's approximate age; and (iv) an indication of the customer's previous investment and futures trading experience.[18] Interestingly, if the customer refuses to provide such information, the CTA or CPO merely makes a notation of the refusal, and the rule does not require such a record to be made in the case of a non-U.S. customer.[19] For institutional customers, the CTA or CPO must obtain a certified resolution or other document authorizing such institution to transact in commodity futures and options.[20] The corporate resolution must be sealed and the documents must include a designation of all persons authorized to act on behalf of the entity.[21] Additionally, the

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[13] NYSE Rule 405.

[14] Commodity Exchange Act of 1974, 7 U.S.C. § 1a *et seq.*

[15] NFA Compliance Rule 2-30. Customer Information and Risk Disclosure [hereinafter, "NFA Rule 2-30"].

[16] A "commodity trading advisor" means any person who (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in (I) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of the contract market; (II) any commodity option authorized under section 4c; or (III) any leverage transaction authorized under section 19; or (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning the activities referred to in clause (I). *See* 7 U.S.C. § 1a(5).

[17] A "commodity pool operator" means any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or indirectly through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order. *See* 7 U.S.C. § 1a(4).

[18] NFA Rule 2-30.

[19] *See id.*

[20] *See id.*

[21] *See id.*

documents must indicate what type of trading the individual(s), who are authorized to trade for the account, are allowed to do.[22]

The new Patriot Act legislation,[23] signed into law on October 26, 2001, contains the most significant anti-money laundering provisions since the 1970 passage of the Bank Secrecy Act. During 2002, several agencies will promulgate many regulations implementing key provisions of the law.

III. USA PATRIOT ACT OF 2001

The Patriot Act provides simply that "each financial institution shall establish anti-money laundering programs."[24] Although simple, this statement will have widespread ramifications in the financial services industry. The new duties imposed by the Patriot Act will have four requirements: (i) development of internal policies, procedures, and controls; (ii) designation of a compliance officer; (iii) provision of on-going employee training programs; and (iv) performance of independent audits to test programs.[25] The foregoing requirements are effective 180 days from the enactment of the Patriot Act.[26] In addition, Treasury must prescribe regulations within that 180-day period that consider the extent to which the requirements imposed under Section 352 of Title III of the Patriot Act are commensurate with the size, location, and activities of the financial institutions to which such regulations apply.[27]

Section 326 of Title III requires the Treasury, jointly with the Securities and Exchange Commission (SEC) and other specified federal regulators, to adopt regulations setting forth minimum standards for financial institutions with regard to the identification and verification of customers in the opening of an account.[28] The regulations, at a minimum, will require financial institutions to implement "reasonable procedures" to verify the identity of any person seeking to open an account, maintain records of the information used to verify a person's identity and consult government lists of known and suspected terrorists or terrorist organizations.[29] In adopting these regulations, Title III specifically requires Treasury to consider various types of accounts maintained by different financial institutions, methods of opening accounts, and types

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[22] *See id.*

[23] H.R. 3162, "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001" (USA Patriot Act of 2001)[hereinafter, the "Patriot Act"].

[24] *See* 31 U.S.C. § 5318(h)(1). Applies to all "financial institutions" as defined in the Patriot Act unless "exempted" by the Treasury Department. This took effect on April 24, 2002.

[25] *See* 31 U.S.C. § 5318(h).

[26] *See* Patriot Act at § 352(b).

[27] See *id.* at § 352(c).

[28] *See* 31 U.S.C. § 5318(a)(1).

[29] *See* 31 U.S.C. § 5318(a)(2).

of information available to make identifications.[30] Final regulations are required to take effect within one year from the legislation's enactment.[31]

A. IMPACT ON BROKER-DEALERS

For purposes of the Act, a broker-dealer[32] is a "financial institution" subject to the reporting requirements discussed in Title III, Section 356 of the Patriot Act. The Secretary of the Treasury (the Secretary), after consultation with the SEC and the Board of Governors of the Federal Reserve System (Federal Reserve) must publish proposed regulations in the Federal Register before January 1, 2002 that require brokers and dealers registered with the SEC under the Securities Exchange Act of 1934 (1934 Act) to submit SARs.[33] Such regulations must be published in final form not later than July 1, 2002.[34]

According to the GAO Report, *Anti-Money Laundering Efforts in the Securities Industry*,[35] one question being debated is whether the $5,000 threshold for reporting suspicious activities that applies to banks should also apply to the securities industry. The GAO Report indicates that "[s]ecurities industry and regulatory officials explained that this reporting threshold reflects the cash-intensive nature of the banking industry and its vulnerability to money laundering at the placement stage and, as such, should not be applied to [broker-dealers]."[36] The GAO Report also states that the banking threshold does not reflect the numerous high-dollar securities transactions that range from $25,000 to $100,000 and that large securities firms currently use thresholds ranging from $250,000 to $1 million in their proprietary systems for monitoring suspicious transactions.[37] Moreover, securities industry representatives also pointed out that a low SAR threshold could result in an inordinate number of SAR filings from the industry, which might undermine the ability of law enforcement agencies to use the reports effectively.[38] Interestingly, according to the GAO Report, "Federal Reserve officials supported a

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[30] *See* 31 U.S.C. § 5318(a)(3).

[31] *See* 31 U.S.C. § 5318(a)(6).

[32] A broker-dealer registered with the SEC is defined as a "financial institution" under the Bank Secrecy Act. *See* 31 U.S.C. § 5312(a)(2)(G).

[33] *See* 31 U.S.C. § 5318(g).

[34] *See* Patriot Act at § 356(a).

[35] *See* United States General Accounting Office, Report to the Chairman, Permanent Subcommittee on Investigations, Committee on Government Affairs, U.S. Senate, Anti-Money Laundering Efforts in the Securities Industry (October 2001)[hereinafter "GAO Report"].

[36] *Id*. at 19.

[37] *See id*.

[38] *See id*.

higher SAR threshold for the securities industry, in part because they thought it could help justify a higher reporting threshold for the banking industry as well."[39]

B. Impact on Hedge Funds

Section 356(c) of Title III of the Patriot Act requires the Treasury, the Federal Reserve and the SEC to jointly submit a report to Congress no later than one year after the date of enactment of the Patriot Act, with recommendations for effective regulations that would apply the requirements of the BSA to investment companies.[40] For these purposes, "investment companies"[41] include both entities that are investment companies under the Investment Company Act of 1940 (1940 Act) and entities that would be investment companies under the 1940 Act but for Sections 3(c)(1)[42] or 3(c)(7)[43] of the 1940 Act, *i.e.*, hedge funds. Section 356(c)(3)

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[39] *Id.* at 20.

[40] The Bank Secrecy Act also includes an investment company in the definition of a "financial institution". *See* 31 U.S.C. § 5312(a)(2)(I).

[41] 15 U.S.C. § 80a-3(a)(1) states:

When used in this subchapter, "investment company" means any issuer which -

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

(2) As used in this section, "investment securities" includes all securities except
(A) Government securities,
(B) securities issued by employees' securities companies, and
(C) securities issued by majority-owned subsidiaries of the owner which
(i) are not investment companies, and
(ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c) of this section.

[42] 15 U.S.C. § 80a-3(c)(1) states:

Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Such issuer shall be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 80a-12(d)(1) of this title governing the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer. For purposes of this paragraph:

specifically provides that the recommendations may be different for the different types of investment companies covered. To date, the SEC has not yet issued proposed regulations. When issued, those regulations will be likely to affect both U.S. and offshore investment companies with respect to the filing of SARs and minimum standards for the identification and verification of customers opening an account as part of an overall anti-money laundering compliance program mandated by the Patriot Act.[44]

According to Title III, Section 356(b) of the Patriot Act, the Secretary, in consultation with the Commodity Futures Trading Commission (CFTC) may prescribe regulations requiring

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(A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, and is or, but for the exception provided for in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper).

(B) Beneficial ownership by any person who acquires securities or interests in securities of an issuer described in the first sentence of this paragraph shall be deemed to be beneficial ownership by the person from whom such transfer was made, pursuant to such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter, where the transfer was caused by legal separation, divorce, death, or other involuntary event.

[43] 15 U.S.C. § 80a-3(c)(7) states:

Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(A) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. Securities that are owned by persons who received the securities from a qualified purchaser as a gift or bequest, or in a case in which the transfer was caused by legal separation, divorce, death, or other involuntary event, shall be deemed to be owned by a qualified purchaser, subject to such rules, regulations, and orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(B) Notwithstanding subparagraph (A), an issuer is within the exception provided by this paragraph if -

(i) in addition to qualified purchasers, outstanding securities of that issuer are beneficially owned by not more than 100 persons who are not qualified purchasers, if -

(I) such persons acquired any portion of the securities of such issuer on or before September 1, 1996; and
(II) at the time at which such persons initially acquired the securities of such issuer, the issuer was excepted by paragraph (1); and

(ii) prior to availing itself of the exception provided by this paragraph -
(I) such issuer has disclosed to each beneficial owner, as determined under paragraph (1), that future investors will be limited to qualified purchasers, and that ownership in such issuer is no longer limited to not more than 100 persons; and (II) concurrently with or after such disclosure, such issuer has provided each beneficial owner, as determined under paragraph (1), with a reasonable opportunity to redeem any part or all of their interests in the issuer, notwithstanding any agreement to the contrary between the issuer and such persons, for that person's proportionate share of the issuer's net assets.

[44] *See* 31 U.S.C. § 5318(a)(1).

futures commission merchants (FCMs), CTAs, and CPOs registered under the CEA to submit SARs (the latter two registrants may be sponsors to U.S.-based hedge funds).[45] It is important to note that the term "investment adviser"[46] is absent from the Patriot Act's definition of "financial institution." Therefore, the Patriot Act technically has no applicability to investment advisers. One would expect, however, that this technical oversight will be corrected either through subsequent legislation or regulation and that any proposed regulation will also apply to unregistered advisers which primarily manage both U.S. and offshore hedge funds.

In addition problems within the SAR rule itself, some unique characteristics of the securities industry, including the variety of business structures and processes, product lines, and client bases, may complicate implementation of the rules.[47] Because not all firms in the industry perform similar activities, firms may have to work with other firms, such as prime brokers, fund administrators, and registrar and transfer agents, to fulfill their SAR-related responsibilities.[48]

IV. PROPOSED, INTERIM AND FINAL REGULATIONS

C. GENERAL

The Patriot Act requires the Treasury to issue implementing regulations. Accordingly, on December 21, 2001, the Treasury issued three proposed regulations[49] under the BSA that affect every securities dealer and "non-financial business" in the United States and nearly all banks outside the United States.

One set of regulations became effective on July 1, 2002, and require approximately 8,000 broker-dealers in the U.S. to report suspicious activity in a way similar to that of the current reporting system for banks. A special reporting form is being devised by Treasury and will be issued in 2002.[50] The proposed rule would codify, with some modifications, interim guidance that the Treasury issued on November 20, 2001 for depository institutions, and extend the same requirements to broker-dealers. It is not yet clear how the proposed regulations for due diligence

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[45] *See id.* at § 5318(h). It should be noted that the Bank Secrecy Act includes in the definition of a "financial institution" a broker or dealer in securities or commodities. *See* 31 U.S.C. § 5312(a)(2)(H).

[46] "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or though publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. *See* 15 U.S.C. § 80b-2(11).

[47] *See* GAO Report at 21.

[48] *See id.*

[49] *See* Final Regulations, Department of the Treasury, Internal Revenue Service, 26 C.F.R. 1.6050I-0; Notice of Proposed Rulemaking, Department of the Treasury, 31 C.F.R. § 104.10 *et seq.* [hereinafter, "Proposed Rulemaking"].

[50] *See* Interim Rule, Department of the Treasury, Financial Crimes Enforcement Network, 31 C.F.R. § 103.30 *et seq.* [hereinafter "Interim Rule"].

for private banking and correspondent accounts and the prohibition against shell banks will apply to broker-dealers in their role as principal underwriter/distributor for an investment company, as that term is defined in the Patriot Act. The Investment Company Institute (ICI), however, has indicated that these regulations will apply also to registered broker-dealers, including mutual fund principal underwriters.[51] In addition, another set of proposed regulations would require broker-dealers to implement anti-money laundering compliance programs by April 24, 2002. Therefore, the proposed regulations that appear most relevant effect the following categories: (1) reporting of suspicious activities; (2) recordkeeping; and (3) implementing an anti-money laundering compliance program.

It should be noted that international banks do not limit their correspondent accounts in the United States to commercial banks. They also keep many such accounts at broker-dealers.[52] In one of its recently issued proposed regulations,[53] Treasury cites several types of accounts that U.S. broker-dealers provide to foreign banks, which may also be relevant to hedge funds. Among them:

- "omnibus accounts for trading on behalf of the foreign bank's customers on a fully disclosed or non-disclosed basis"[54]
- "prime brokerage accounts that consolidate trading done at a number of firms and lend stock"[55]
- "various forms of custody accounts for the foreign bank and its customers."[56]

The Treasury issued another set of regulations on April 23, 2002 that apply to broker-dealers, among other financial institutions, and would require the establishment of anti-money laundering compliance programs. The Treasury imposed, however, a temporary suspension of the requirement for exempted investment companies (hedge funds), commodity pool operators, and commodity trading advisors.

D. REQUIREMENTS UNDER U.S. LAW

1. *Availability of Bank Records*

Some provisions in the Patriot Act will assist in the procurement of certain records from covered financial institutions for applicable federal regulators and law enforcement authorities.[57]

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[51] *See* Investment Company Institute Memorandum No. 14287, Treasury Proposes Broker-Dealer Suspicious Activity Reporting Rules and Other Rules to Implement the USA Patriot Act, January 8, 2002.

[52] *See generally* Money Laundering Alert, January 2002.

[53] *See* 31 C.F.R. § 104.10 *et seq.*

[54] *Id.* at 8.

[55] *Id.*

[56] *Id.*

Another provision requires a covered financial institution, upon request of the appropriate federal regulator, to produce records relating to anti-money laundering compliance or its customers within 120 hours of the request.[58]

Furthermore, the Patriot Act allows the Treasury or the United States Attorney General to issue a subpoena or summons to any foreign bank with a correspondent account in the United States and request records relating to that account, including records maintained abroad about deposits into the foreign bank. These records must be provided within seven days.[59] A covered financial institution, such as a broker-dealer, that has a correspondent account for a foreign bank must maintain in the United States: (1) records identifying the owners of the foreign bank; and (2) the name and address of a person in the United States who is authorized to accept service of legal process on behalf of the foreign bank.[60] This means that the foreign bank must designate an agent for services of process. The Treasury has developed a "certification" process to assist covered financial institutions to comply with Sections 313 and 319(b) of the Patriot Act. It worked with industry officials and other federal regulators in developing the process.[61]

2. *Broker-Dealer Suspicious Activity Reporting*

Pursuant to the Patriot Act, the Treasury issued a proposed rule that would require every "broker or dealer in securities" to file with the Treasury's Financial Crimes Enforcement Network (FinCEN) a report of any suspicious transaction relevant to a possible violation of law or regulation.[62] The proposed rule applies to "any known or suspected violation of Federal law, or a suspicious transaction related to a money laundering violation or a violation of the BSA."[63] Pursuant to the proposed rule, the definition of "transaction" is expansive and would expressly include transactions involving any "security" as defined in Section 3(a)(10) of the 1934 Act.[64]

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[57] *See* 31 U.S.C. § 5318(k) (effective date Dec. 25, 2001). *See generally* Federal Reserve Board, Supervisory Letter SR 01-29 on the USA Patriot Act and the International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001 [hereinafter "SR Letter"].

[58] *See id.* at 2.

[59] *Id.*

[60] *See id*. at 2-3.

[61] *See id. See also* Interim Guidance, Department of the Treasury, November 21, 2001 [hereinafter, "Interim Guidance"].

[62] *See* 66 Fed. Reg. 67670 (Dec. 31, 2001). *See* 31 U.S.C. § 5318(g).

[63] 66 Fed. Reg. 67670.

[64] 66 Fed Reg. at 67672.

Under the proposal, a transaction is reportable[65] if it:

(a) is conducted or attempted by, at, or through a broker-dealer;[66]

(b) involves or aggregates funds or other assets of at least $5,000;[67] and

(c) is either:

(i) a transaction involving a known or suspected Federal criminal violation committed or attempted against or through a broker-dealer;[68] or

(ii) a transaction that the broker-dealer knows, suspects , or has reason to suspect:[69]

(1) involves funds derived from illegal activity or intended or conducted in order to hide or disguise funds or assets derived from illegal activity;[70]

(2) is designed, whether through structuring or other means, to evade the requirements of the BSA;[71] or

(3) appears to serve no business or apparent lawful purpose, and for which the broker-dealer knows of no reasonable explanation after examining the available facts relating to the transaction.[72]

Within thirty days after the broker-dealer becomes aware of the transaction, it must report the transaction.[73] The reports would be made on Form SAR-BD, which "will resemble the SAR used by banks to report suspicious transactions."[74] Broker-dealer suspicious activity reports (like

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[65] *See* 66 Fed. Reg. at 67673 n.20. Voluntary reporting of transactions not required to be reported is specifically permitted, but would not relieve a broker-dealer from any applicable reporting requirements imposed by the SEC or any self-regulatory organization (SRO).

[66] *See id*. at 67672.

[67] *See id*.

[68] *See id*. at 67673.

[69] *See id*. According to the notice of proposed rulemaking, "the 'knows, suspects, or has reason to suspect' standard incorporates a standard of due diligence in the reporting requirement."

[70] *See id*.

[71] *See id.*

[72] *See id*.

[73] *See id.* 67674.

those filed by other types of financial institutions) would be maintained by FinCEN in an automated database.[75]

Under the proposed rule, broker-dealers also would be required to maintain copies of SAR-BDs and supporting documentation for five years from the date of filing.[76] Broker-dealers must also properly identify original related documentation and make those documents available upon request to FinCEN, any other appropriate law enforcement and regulatory authorities, and any SRO examining the broker-dealer from compliance with the rule.[77]

The proposed rule also prohibits any financial institutions and their directors, officers, employees and agents from notifying any person involved in a suspicious activity transaction that the transaction has been reported.[78] In addition, broker-dealers would be required to decline any subpoena request for a SAR-BD, unless FinCEN, the SEC, or another appropriate law enforcement or regulatory agency requests disclosure, or an SRO asks the broker-dealer for compliance with the rule.[79] Broker-dealers must notify FinCEN of any such request and the response made.[80]

There is a safe harbor, however, that protects the broker-dealer and any director, officer, employee or agent who makes a report from liability to any person for making reports of suspicious transactions, and for failing to disclose the facts of such reporting.[81] The safe harbor also extends to arbitration proceedings.[82]

3. *Anti-Money Laundering Compliance Program for Broker-Dealers*

The SEC approved NASD proposed Rule 3011 on April 22, 2002.[83] As of April 24, 2002, each broker-dealer that is a NASD member will have developed and implemented a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations

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[74] A draft form will be made available for comment in the Federal Register.

[75] *See* 66 Fed. Reg. at 67674.

[76] *See id.*

[77] *See id.*

[78] *See id.*

[79] *See id.*

[80] *See* 66 Red. Reg. 6764.

[81] *See id.*

[82] *See id.*

[83] *See* Securities Exchange Act Release No. 45798 (Apr. 22, 2002); NASD Regulation – Rule Filing 2002-24 [hereinafter, "SR-NASD-2002-24"]. *See* 31 U.S.C. § 5318(h).

promulgated thereunder by the Treasury.[84] Each member organization's anti-money laundering program must be approved, in writing, by a member of senior management. The anti-money laundering program required by this Rule will, at a minimum:

(a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder;[85]

(b) Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and the implementing regulations thereunder;[86]

(c) Provide for independent testing for compliance to be conducted by member personnel or by a qualified outside party;[87]

(d) Designate an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program;[88] and

(e) Provide on-going training for appropriate personnel.[89]

4. *Anti-Money Laundering Compliance Programs for Hedge Funds*

The Treasury and FinCen, pursuant to their authority under BSA Section 5318(a)(6), have decided to exempt temporarily certain financial institutions from the requirement in Section 5318(h)(1) that they establish anti-money laundering compliance programs.[90] The temporary exemption in regulation Section 103.170 applies to certain investment companies, commodity pool operators, and commodity trading advisors.[91]

Under federal law, investment companies are governed by the 1940 Act[92] which defines the term "investment company"[93] to encompass several different types of entities. Entities such

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[84] The NASD issued a Special Notice to Members to provide guidance to NASD member firms concerning anti-money laundering programs required by federal law. *See* Special NASD Notice to Members 2-21 (Apr. 2002).

[85] *See* SR-NASD-2002-24 at 3.

[86] *See id.*

[87] *See id.*

[88] *See id.*

[89] *See id.*

[90] *See* Department of the Treasury, Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Financial Institutions, Interim Final Rule, 31 C.F.R. Part 103 [hereinafter, "Interim Final Rule"].

[91] 31 C.F.R. § 103.170 (2002).

[92] 15 U.S.C. § 80a1-80a64.

[93] *See supra* note 41.

as hedge funds, private equity funds, and venture capital funds are specifically excluded from the definition of investment company for purposes of the 1940 Act either pursuant to Section 3(c)(1)[94] or Section 3(c)(7).[95] Section 356 of the Patriot Act requires the Treasury, Federal Reserve and SEC to submit a joint report to Congress not later than October 26, 2002.[96] The report must contain recommendations for regulations that implement the requirements of the BSA with respect to investment companies, including entities that, but for exemptions or exclusions, would be investment companies under the 1940 Act.[97] Accordingly, the Treasury anticipated that the CFTC would be a participant in the development of this report because a significant percentage of hedge funds are registered and regulated as commodity pool operators.[98] Therefore, subject to further review, the Treasury has temporarily exempted investment companies, other than "open-end companies," (commonly referred to as "mutual funds") as defined in Section 5(a)(1)[99] of the 1940 Act, from the requirements of BSA Section 5318(h)(1).[100] In addition, subject to further review, the Treasury also deferred a determination of the scope of the BSA definition of "investment company," but anticipated that it was likely that unregistered investment companies, otherwise excluded from the application of the 1940 Act, would be subject to anti-money laundering program requirements.[101]

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[94] 15 U.S.C. § 80a-3(c)(1). *See supra* note 42.

[95] 15 U.S.C. § 80a-3(c)(7). *See supra* note 43.

[96] Patriot Act at § 356.

[97] *Id.*

[98] Interim Final Rule at 8 n.7. *See supra* note 17.

[99] 15 U.S.C. § 80a-5(a)(1) states an "open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer. Note, Treasury issued an interim final rule regarding anti-money laundering programs for mutual funds that is effective on April 24, 2002 with compliance required by July 24, 2002. *See generally* Department of the Treasury, Financial Crimes Enforcement Network; Anti-Money Laundering Program for Mutual Funds, Interim Final Rule, 31 C.F.R. § 103.130 *et seq*.

[100] *See* Interim Final Rule at 8 n.7.

[101] *See id.* Despite this, the Managed Funds Association ("MFA"), a U.S.-based trade group representing hedge funds and hedge fund managers, issued preliminary guidance for hedge funds and hedge fund managers on developing anti-money laundering compliance programs. Accordingly, "MFA believes that hedge funds and their hedge fund managers should adopt effective anti-money laundering programs for a number of compelling reasons, including (but not limited to) ensuring compliance with applicable blocking statutes and other restrictions on assisting money laundering and terrorist financing, satisfying the potential requirements of prime brokers and other institutions subject to the provisions of and regulations promulgated under the USA Patriot Act and the Bank Secrecy Act regarding the soundness of their customer due diligence procedures and minimizing exposure to reputational and legal risks…." Managed Funds Association, Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs, March 2002 (Release No. 1), at 2 [on file with author].

CONCLUSION

Although the Act is hardly a panacea for all of the assorted ills of money laundering, at a minimum it is a firm declaration of intent. The Act will have a significant impact on broker dealers and hedge funds (unregistered investment companies) and, eventually, their investment advisers (both registered and unregistered). Therefore, it will be incumbent upon practitioners and compliance professionals, in conjunction with U.S. and global regulators, to execute the mandates of the Act and the regulations that will be promulgated under it in order to restrict the scope and breadth of money laundering on a global scale.

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