SELF-GOVERNMENT IN THE SECURITIES BUSINESS*

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The increasing burden of government is of universal concern. As the state and its processes become more unwieldy there are some, at least, who look with hope to the assumption by non-state agencies of a portion of the task of social control.

The modern development of arbitration reflects dissatisfaction with the state's means for settling disputes between people. Far less developed are means for regulating, through non-state agencies, relations between people and their community. Whatever hope may have sprung from *Appalachian Coals, Inc. v. United States*¹ that the antitrust laws would tolerate a measure of business self-government, later cases have sharply restricted the possibilities.² But demand for such self-government continues and society has a way of responding to demand.

In a manner thus far unique in our economic life, the securities business has evolved social controls through private agencies which are drastic and extensive. This article undertakes briefly to examine certain phases of the relationship between the state and the private agencies exercising control over the members of that business.

Generally speaking, trading in securities occurs through two media. One is the organized exchange. The other is the over-the-counter market. The exchange is a specific market place, with a limited number of stalls. The over-the-counter market is quite unlimited; any number of traders (*i.e.*, broker-dealers) may participate in it anywhere at any time.³

In the case of the organized exchanges our inquiry must be directed principally to the decisions of courts applying common-law rules. In the case of the over-the-counter market our inquiry must be directed to decisions of an administrative agency, the Securities and Exchange Commission, applying a statutory system.

THE EXCHANGES

No court has yet held that the antitrust laws affect the freedom of stock exchanges to decline to admit new members,⁴ or to regulate the admission of members; and

* SEC Releases cited in this article are those issued under the Securities Exchange Act of 1934. Such Releases are generally reported in CCH, Federal Securities Law Reports, but not always in full.

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¹ 288 U. S. 344 (1933).

² *Fashion Originators' Guild of America v. Federal Trade Commission*, 312 U. S. 457 (1941).

³ Neither state nor federal law restricts the number of such traders for economic reasons, even where there is a licensing procedure. The amount of over-the-counter trading exceeds trading on the organized exchanges. REGULATION OF OVER-THE-COUNTER MARKET, SEN. REP. NO. 1455, 75th Cong., 3d Sess. 2 (1938), H. R. REP. NO. 2307, 75th Cong., 3d Sess. 3 (1938).

⁴ *But cf. United States v. Tarpon Springs Sponge Exchange*, 142 F.2d 125, 127 (5th Cir. 1944), upholding the sufficiency of a Sherman Act indictment alleging, among other elements of a conspiracy, the restriction of membership as an "exchange" dealing in sponges "saw fit."

this freedom is accompanied by a freedom to adopt rules as to the conduct of the members which are enforced by the power to expel. An exchange may, for example, require its members not to deal with non-members, and may fine or expel them if they do, without violating the Sherman Act.⁵ More than that, it has been decided that the antitrust laws permit an exchange to require that its members, even in trading outside the precincts of the exchange, adhere to certain exchange rules as a condition of retention of membership.⁶ The fact is that stock exchanges seem to have been permitted to function almost as though there were no antitrust problem at all. Except for other statutory regulation, to which we shall later refer, the technical relationship of the exchange to the state is, roughly, the same as the relationship of a private club.⁷

It is obvious that under this construction of the antitrust laws the state's regulation of the relations between the exchanges and their members is very restricted, or was so before the passage of the securities legislation of 1933-1934. In consequence, the practices of the securities exchanges constitute an outstanding example of the extent to which largely private regulation of an important part of economic life can take the place of governmental control.

The rules which a stock exchange can adopt as a means of controlling the securities business fall into three categories: (1) those regulating the dealings of members among themselves; (2) those regulating the conduct of members in dealing with the public; and (3) those regulating the conduct of corporations whose securities are listed by the exchange and traded in by exchange members. All three kinds of rules may have a distinct effect on society as a whole.⁸ Since all three are ultimately enforced by the sanction of expulsion (or removal from listing of the stock of a particular corporation), the effectiveness of the sanction measures the effectiveness of the rules themselves.

In upholding suspensions or expulsions of stock exchange members for infractions of exchange rules, the courts have ordinarily relied on contract doctrines to support procedures which they would be quick to condemn if contained in a statute, and substantive rules which, if rules of statutory law, might well have been invalidated as arbitrary and capricious.⁹

In the realm of procedure, for example, an accused exchange member is not

⁵ *Anderson v. United States*, 171 U. S. 604 (1898) (alternative holding).

⁶ *Board of Trade of the City of Chicago v. United States*, 246 U. S. 231 (1918).

⁷ See *Belton v. Hatch*, 109 N. Y. 593, 17 N.E. 225, 226 (1888) (making the club analogy in speaking of the New York Stock Exchange).

⁸ For example, a "housekeeping" rule giving the exchange a lien on the proceeds of a member's seat for litigation expenses in connection therewith may operate to defeat the outside creditor of a member even though his claim was reduced to judgment before the exchange rule was adopted. *Jackson v. New York Cotton Exchange*, 259 App. Div. 329, 19 N. Y. S. 2d 207 (1st Dep't 1940). *But cf.* *Cohen v. Budd*, 52 Misc. 217, 103 N. Y. Supp. 45 (Sup. Ct. 1906) (exchange rule cannot defeat right of trustee in bankruptcy to assets owed bankrupt member by other members).

⁹ For the courts' reliance on the contract between the member and the exchange as the basis for expulsion according to the terms of the contract, *cf.* *Cohen v. Thomas*, 209 N. Y. 407, 103 N. E. 708 (1913).

entitled to be represented by counsel in expulsion proceedings if the constitution or bylaws forbid.¹⁰ Even notice that expulsion proceedings are about to be brought or that a member has been suspended, though essential when the constitution and bylaws are silent,¹¹ need not be given when the "contract" between member and exchange excludes it.¹²

An exchange need not give notice to a member that it is conducting an investigation which may lead to the filing of charges against him unless its constitution and bylaws so require.¹³ The question of what the constitution and bylaws do or do not require—their "interpretation"—can be conclusively determined by the exchange's board of governors if their power to do so is granted thereby.¹⁴

When an expulsion proceeding takes place, it is proper for exchange members or officials who preferred charges to sit on the tribunal which must determine the truth of such charges and the penalty for violation.¹⁵

In *Board of Trade of the City of Chicago v. Nelson*, the Illinois Supreme Court held itself powerless even to inquire into the sufficiency of the evidence to support an expulsion from the Board on the ground that the complainant had been convicted by "a tribunal of his own choice."¹⁶ More recent cases take a less rigid position: in the *Avery* case the court looked to see whether there had been "some substantial evidence" of a violation of the exchange's constitution and bylaws before the exchange tribunal.¹⁷

This review of some of the cases shows that the courts have given great latitude to

¹⁰ *Greene v. Board of Trade of the City of Chicago*, 174 Ill. 585, 51 N. E. 599 (1898); see *Moyse v. New York Cotton Exchange*, 70 Misc. 609, 613 129 N. Y. Supp. 173, 175-176 (Sup. Ct. 1911), *aff'd*, 143 App. Div. 265, 128 N. Y. Supp. 112 (1st Dep't 1911) (approving the *Greene* case, but suggesting that respondent might demand counsel if bylaws are silent).

¹¹ See *People ex rel. Johnson v. New York Produce Exchange*, 149 N. Y. 401, 409, 44 N. E. 84, 85 (1896) (obiter statement that notice of expulsion proceedings is "a fundamental principle of justice"); *Williamson v. Randolph*, 48 Misc. 96, 98, 96 N. Y. Supp. 644, 646 (Sup. Ct. 1905).

¹² *People ex rel. Dodson v. Board of Trade of Chicago*, 224 Ill. 370, 79 N. E. 611 (1906) (upholding exchange's suspension of member without notice for non-payment of dues and forfeiture of his membership on ground that bylaw excluded notice and relator was familiar therewith).

¹³ *Greene v. Board of Trade of the City of Chicago*, 174 Ill. 585, 51 N. E. 599 (1898).

¹⁴ *Avery v. Moffatt*, 187 Misc. 576, 55 N. Y. S. 2d 215 (Sup. Ct. 1945). Mere "practice" or "custom" of an exchange, however, cannot defeat an explicit provision of its constitution. In the face of such a provision the accused member, for example, cannot be deprived of his right to confront and cross-examine witnesses at the expulsion trial by a long-established custom of confining the evidence to a reading of testimony taken at the preliminary investigation. *Jones v. Moffatt*, 183 Misc. 129, 50 N. Y. S. 2d 233 (Sup. Ct. 1944), *aff'd without opinion*, 268 App. Div. 967 51 N. Y. S. 2d 767 (1st Dep't 1944).

¹⁵ *Avery v. Moffatt*, *supra* note 14. See *Greene v. Board of Trade of the City of Chicago*, 175 Ill. 585, 51 N. E. 599 (1898). The court in the *Avery* case said that this procedure "goes against the grain" and "has given the court deep concern" (187 Misc. at 584, 55 N. Y. S. 2d at 222) but finally concluded that it was proper, relying in part on the brief filed by the SEC showing that the same procedure was prescribed by the rules of most stock exchanges.

¹⁶ 162 Ill. 431, 440, 44 N. E. 743, 746 (1896). The *Nelson* case was questioned on this point in *In re Rosenbaum Grain Corp.*, 13 F. Supp. 601, 605 (N. D. Ill. 1935).

¹⁷ *Avery v. Moffatt*, 187 Misc. 576, 583, 55 N. Y. S. 2d 215, 220 (Sup. Ct. 1945); *cf. People ex rel. Johnson v. New York Produce Exchange*, 149 N. Y. 401, 414, 44 N. E. 84, 87 (1896) (only question of sufficiency of evidence on appeal is whether the record before the exchange tribunal is so "bare of evidence" that no "honest mind" could find as the tribunal did).

exchanges in enforcing their own discipline. Though a few cases have required exchanges to reinstate members expelled without adherence to their own rules of procedure¹⁸ or for violation of a bylaw interpreted unreasonably,¹⁹ the courts have unanimously taken the attitude that exchange members, as parties to a voluntary contract with the exchange, must abide by their agreement. If the exchange has followed its own procedural rules in expelling a member for violation of a bylaw in a proceeding not wholly devoid of "natural justice," the proceeding is not reviewable.²⁰ It is irrelevant that the exchange's determination was wrong or that the court would have imposed a lesser penalty.²¹ The *Avery* case, for example, involved suspension of two exchange members (for 6 and 18 months respectively) for wrongful acts of their firm and the firm's dominant partner of which they were without knowledge.²² The court acknowledged that this discipline was "severe," but upheld it because it was not so "arbitrary" or "tyrannical" as to permit judicial interference—particularly since suspension of personally innocent members for their firms' defaults was permitted by the constitution of the exchange, to which they had subscribed.²³

The courts have taken much the same attitude toward substantive rules of the exchanges. If the rule seems even remotely reasonable, it will be upheld over the protests of a member expelled for its violation, because he contracted to abide by it. Some courts even hold exchange members estopped to question the reasonableness of exchange rules in existence at the time of their admission.²⁴

Take as a single example the question of breach of contract by an exchange member. Many exchanges have specific rules providing discipline for their members' breaches of contract; almost all permit expulsion for conduct inconsistent with just and equitable principles of trade. The Supreme Court of Illinois, always liberal with exchanges, long ago held that an exchange might expel a member for simple non-fraudulent breach of contract if its bylaws so provided.²⁵ To the contention that such a bylaw was unjust and unreasonable the court had the short

¹⁸ *E.g.*, *Albers v. Merchants' Exchange of St. Louis*, 138 Mo. 140, 39 S. W. 473 (1897) (unauthorized suspension of member who in good faith contested validity of fine).

¹⁹ *E.g.*, *People ex rel. Elliott v. New York Cotton Exchange*, 8 Hun 216 (N. Y. Sup. Ct. 1876) (member's resort to courts to determine ownership of seat held not "improper conduct" for which he could be expelled, in absence of explicit provision for exchange's determination of right to seat); *cf.* *Stein v. Marks*, 44 Misc. 140, 89 N. Y. Supp. 921 (Sup. Ct. 1904) (bylaw which changed purposes of incorporated club).

²⁰ *Cohen v. Thomas*, 209 N. Y. 407, 103 N. E. 708 (1913).

²¹ *People ex rel. Johnson v. New York Produce Exchange*, 149 N. Y. 401, 44 N. E. 84 (1896); *Young v. Eames*, 78 App. Div. 229, 240, 79 N. Y. Supp. 1068, 1075 (1st Dep't 1903), *aff'd without opinion*, 181 N. Y. 542, 73 N. E. 1134 (1905); *Board of Trade of the City of Chicago v. Nelson*, 162 Ill. 431, 44 N. E. 743 (1896).

²² Quare the disparate suspensions.

²³ *Avery v. Moffatt*, 187 Misc. 576, 583, 55 N. Y. S. 2d 215, 220-221 (Sup. Ct. 1945).

²⁴ *Bostedo v. Board of Trade of the City of Chicago*, 130 Ill. App. 560 (1906), *aff'd*, 227 Ill. 90, 81 N. E. 42 (1907) (suggesting also that courts are powerless to inquire into reasonableness of exchange rules).

²⁵ *People ex rel. Page v. Board of Trade of the City of Chicago*, 45 Ill. 112 (1867); see *People ex rel. Johnson v. New York Produce Exchange*, 149 N. Y. 401, 410, 44 N. E. 84, 86 (1896).

and sound answer that the exchange had been formed to promote high standards of commercial honor and credit and that this was a good way of doing just that. The Chicago Board of Trade, the court said, "would soon cease to be respected or respectable if it tolerated among its members a violation of an undisputed contract."²⁶ Even when no bylaw permits expulsion of an exchange member for "mere" breach of contract, he can be expelled for breach of contract which is something less than fraudulent under a bylaw prohibiting conduct "inconsistent with just and equitable principles of trade" whether the contract in question was made on or off the exchange, with a fellow-member or an outsider.²⁷ The Illinois court has permitted expulsion for mere breach of contract under a bylaw proscribing "dishonorable or dishonest conduct."²⁸

Such are the common-law principles which govern securities and other exchanges in enforcing their rules against their own members. The exchanges' powers are plenary; their procedures are summary; their judgment cannot be questioned on appeal.

Stock exchanges have powers at least as effective over the corporations whose securities they list, growing out of the fact that listing is a privilege accorded the corporations by the exchanges. There is *a priori* no reason why this privilege cannot be withheld or withdrawn on any terms the exchanges care to ask. There would appear to be no reason, for example, why a well-established exchange could not condition the listing of securities on disclosure of the financial condition of listed corporations just as full as the disclosure now required under federal law. Perhaps the failure of the exchanges in this and similar respects was one of the causes of the federal security legislation.

The courts appear to have given little consideration to the effect of exchange rules respecting the conduct of listed corporations.²⁹ Such rules are usually embodied in agreements required of corporations as a prerequisite to listing.

One such rule, which reduces corporate directors' opportunities to profit from "inside" knowledge and thereby to bilk the investing public, was adopted under pressure from Congress itself. This is the rule that a listed corporation must give prompt publicity to its dividend actions. The instance would be notable if only because it affords the spectacle of the national legislature threatening remedial action if the existing state of affairs cannot be corrected by enlarging the rules of a voluntary association. Moreover, the rule as finally adopted provides the public an

²⁶ *People ex rel. Page v. Board of Trade of the City of Chicago*, 45 Ill. 112, 116 (1867).

²⁷ *People ex rel. Johnson v. New York Produce Exchange*, 149 N. Y. 401, 44 N.E. 84 (1896) (contract with exchange member); *In re Haebler v. New York Produce Exchange*, 149 N. Y. 414, 44 N.E. 87 (1897) (contract with outsider made outside exchange). In each case the expelled member broke his contract because of price changes occurring between the making of the contract and the delivery date.

²⁸ *Board of Trade of the City of Chicago v. Nelson*, 162 Ill. 431, 44 N. E. 743 (1896).

²⁹ In at least one case, however, a stockholder has sued a listed corporation as third-party beneficiary of a contract between the corporation and the exchange made in conformity to the exchange's listing requirements. Recovery was denied on the contract ground that plaintiff was a mere incidental beneficiary. *Mackubin v. Curtiss-Wright Corp.*, 190 Md. 52, 57 A.2d 318 (1948).

effective guarantee unknown to the law and even now embodied in few if any corporation statutes.

The year 1912 saw a crystallization of both public and congressional opinion concerning the "money trust." It was the culmination of a decade or more of "muck-raking" and "trust-busting." The "money trust" was conceived of as centered in "Wall Street," composed of banks, insurance companies, investment bankers, and the New York Stock Exchange, which was thought to furnish all of them facilities for the "manipulation" of the country's finances. Accordingly, no less than eight resolutions to investigate the "money trust" were introduced in the House alone at a single session in 1912.³⁰ The stock exchanges, particularly the New York Stock Exchange, were thought to be at the heart of the money trust. During 1913 and the early part of 1914, nine bills to regulate stock exchanges were introduced in both houses of Congress.³¹ Almost all these proposed bills sought to deny to stock exchanges the use of the mails and telephone and telegraph facilities unless certain reforms were made and specified public information required from listed corporations.

The report of the so-called Pujo Committee, appointed by the House to investigate the money trust, laid especial stress on the potential function of the New York Stock Exchange's listing requirements in reforming corporate practices and preventing corporate "insiders" from profiting from their knowledge. The Committee was at the same time optimistic about the potential benefit to be secured from proper listing requirements imposed by law, and concerned because, in its view, the Exchange had so completely neglected opportunities to do good. It reported:³²

Great and much-needed reforms in the organization and methods of our corporations may be legitimately worked out through the power wielded by the stock exchange over the listing of securities . . .

. . . complete publicity as to all affairs of a corporation may be uniformly enforced. The scandalous practices of officers and directors in speculating upon inside and advance information as to the action of their corporations may be curtailed, if not stopped. In short its opportunities as an agency of corporate reform are almost endless, provided its own practices can be reformed so as to entitle it to exercise these broad powers . . .

At the time these words were written, the listing requirements of the Exchange contained no provision for the publication of dividend actions by listed corporations. This may be seen from the copy of the Exchange's listing requirements submitted to the Pujo Committee and published as Exhibit 30½ in the hearings before the Committee.³³ Thus without violating any rule of the Exchange a director could

³⁰ See 48 CONG. REC. INDEX 353 (1912).

³¹ See 50 CONG. REC. 91, 227, 239, 279-280, 5282 (1913); 51 CONG. REC. 504, 1498, 3874, 8688, 11075, 11116-11117, 11166-11172 (1914).

³² INVESTIGATION OF FINANCIAL AND MONETARY CONDITIONS IN THE UNITED STATES UNDER HOUSE RESOLUTIONS NOS. 429 AND 504 BEFORE A SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY [hereinafter MONEY TRUST INVESTIGATION], H. R. REP. NO. 1593, 62d Cong., 3d Sess. 114, 115 (1913).

³³ MONEY TRUST INVESTIGATION, *op. cit. supra*, at 413-425.

speculate in his own stock on the certain knowledge that a dividend had or had not been declared, before that knowledge had been given to the public. And the alleged prevalence of this practice was among the reasons that induced the Committee to recommend federal legislative control of stock exchanges.³⁴

Toward the end of 1913, only a few months after the publication of the Money Trust Investigation proceedings, the Stock Exchange was acutely embarrassed by an instance of the very situation which certain members of the Pujo Committee and its counsel had declaimed against. Early in the year, the Goodrich Rubber Co. had declared a dividend payable toward the end of the year. The corporation's action was not disclosed to the public. The directors stated that dividend action had been taken early in the year because the securing of a quorum of the board later in the year was problematical; and the action had not been publicized because interim changes in business conditions might have made it necessary for the dividend to be rescinded.³⁵

On the whole, though the Exchange fully exonerated the directors of Goodrich from any wrongdoing, the transaction emphasized the opportunities which corporate insiders had in such a situation for obtaining substantial profits. Indeed, during the period between declaration of the dividend and the public announcement, Goodrich preferred, the stock in question, had slumped 16 points owing to public fear that the dividend would be passed.³⁶

In view of the activities of Congress and the unfortunate timing of the Goodrich dividend announcement, it is hardly surprising that within a few weeks thereafter the Exchange announced a new listing requirement which obligated listed corporations to agree with the Exchange at the time of listing "to publish promptly to bond and stock holders any action in respect to dividends on shares [or] interest on bonds. . . ."³⁷

The many changes in the securities business brought about by the Securities Exchange Act of 1934³⁸ are well known. It is not so well known that the Act made

³⁴ See Brief of Pujo Committee counsel (Samuel Untermyer) before Senate Committee on Banking and Currency, in support of S. 3895, 63d Cong., 2d Sess. 53 (Mar. 16 1914); *Hearings before Senate Committee on Banking and Currency on S. 3895*, 63d Cong., 2d Sess. 506 (1914); testimony of Harry Content, a Stock Exchange member, *MONEY TRUST INVESTIGATION*, *op. cit. supra* note 32, at 870; testimony of George W. Perkins, a former Morgan partner, *id.* at 1617.

³⁵ It seems a matter of doubt, however, whether a dividend once declared can be rescinded without the stockholders' consent. See 11 FLETCHER, CORPORATIONS §5323 (1932).

³⁶ See the report of the case contained in the New York Times, Dec. 4, 1913, p. 2, col. 4. The sub-headline reads: "Insiders Knew It Was Safe." See also editorial, N. Y. Times, Dec. 5, 1913, p. 10, col. 3: "Even from a purely selfish point of view, the Stock Exchange has much more to gain by taking an advanced stand than it has by holding back until enlightened public opinion on such questions as are here involved [the Goodrich case] secures the sanction of law."

³⁷ The public announcement of the new listing agreement was made on Jan. 16, 1914. See N. Y. Times, Jan. 16, 1914, p. 12, col. 6. The text of the agreement itself is published as Exhibit "D" in *Hearings before the Senate Committee on Banking and Currency on S. 3895*, 63d Cong., 2d Sess. 743 (1914). In testimony before the Senate Committee subsequent to the adoption of the agreement, Henry K. Pomroy, a member of the Board of Governors of the Exchange, explained to Senator Nelson that the new agreement was directly inspired by the Goodrich case. *Id.* at 201. The rule as it existed in 1932 is quoted in *Mackubin v. Curtiss-Wright Corp.*, 190 Md. 52, 54, 57 A.2d 318, 319-320 (1948).

³⁸ 48 STAT. 881, 15 U. S. C. §78 *et seq.* (1934).

very little change in the rights of the stock exchanges to discipline their members and to prescribe conditions of listing for corporate securities. The main effect of the Act with respect to the discipline of exchange members was to add to the exchanges' existing rights the additional right of the Commission under Section 19(a)(3) to suspend or expel members or officers of exchanges who violate either the Act or rules of the Commission.

Section 6(b) of the Act provides that no exchange can be registered with the SEC unless it adopts rules which include "provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade." The SEC appears at one time to have doubted whether it had power to revoke or suspend the registration of an exchange if, after having adopted such rules, the exchange failed to enforce them. In connection with the handling of the notorious Whitney case by the New York Stock Exchange and the handling of the almost equally notorious Cuppia case by the New York Curb Exchange, the SEC in 1941 proposed legislation authorizing it to suspend or revoke an exchange's registration "for failure to enforce compliance with the exchange's rules."³⁹ The requested legislation was not adopted. But in *Baird v. Franklin*⁴⁰ the court held that Section 6(b) of the Act imposed a duty on exchanges to enforce the rules required by that Section. This was a civil suit for damages brought against the New York Stock Exchange by a customer of Richard Whitney's who had suffered from the Whitney defalcations. Although the opinion in the *Baird* case did not discuss the duty to enforce disciplinary rules except with reference to civil liability, it seems at least possible that the SEC might revoke the registration of an exchange for violation of the duty thus established.⁴¹

In any event, despite the passage of the Act the exchanges are still free to adopt and enforce any rule not inconsistent with the Act.⁴² Moreover, "when an exchange does take disciplinary action against a member, the Commission has no jurisdiction to review that action administratively."⁴³ The traditional limited review of such actions by the courts remains unchanged.⁴⁴

The powers of the exchanges with respect to the listing of securities are even less affected by the Act than disciplinary proceedings. Section 19(b)(3) of the Act gives the SEC power to alter or supplement the rules of an exchange relating to listing if the exchange refuses to adopt the SEC's recommendation with respect thereto, but this power has apparently never been exercised. It is characterized by Mr. Loss as a "residual power."⁴⁵

³⁹ This recommendation and its background are summarized in SEC, TENTH ANN. REP. 18-19 (1944).

⁴⁰ 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 328 U.S. 737 (1944).

⁴¹ See LOUIS LOSS, SECURITIES REGULATION 633 (1951). This scholarly treatise is an indispensable reference in the securities field. To avoid repetition we will cite this work only when we would invite attention to a specific passage therein.

⁴² Sec. 6(c).

⁴³ LOSS, SECURITIES REGULATION 633.

⁴⁴ *Ibid.*

⁴⁵ *Id.* at 487; see *id.* at 487-491 for a discussion of the non-statutory listing requirements of various stock exchanges.

THE OVER-THE-COUNTER MARKET

When we turn from the exchange to the over-the-counter market we find quite a different situation.

The Securities Exchange Act of 1934 left the over-the-counter market but slightly affected, even after important amendments to Section 15 of that Act in 1936. In substance, the SEC was simply given very general power to control fraudulent conduct in the over-the-counter market.⁴⁶

Obviously this left quite unregulated, in the over-the-counter market, the whole area of business ethics in the relation between members of the business and between members and their customers which the exchanges have traditionally regulated. A movement quickly developed to bring into the over-the-counter market regulation similar to that which the exchanges provide for their members.⁴⁷

Under the NRA there had been a code regulating the ethics of over-the-counter brokers and dealers. Following the invalidation of the NIRA, the SEC and representatives of those in the business cooperated in seeking legislation which would make it possible to resume such regulation.⁴⁸ The legislation was adopted in 1938. It added to the Securities Exchange Act a new section, 15A, known as the Maloney Act from the name of its sponsor, Senator Maloney. It was introduced in Congress at the SEC's request.⁴⁹ It represented a deliberate choice by Congress between two alternatives: greatly expanding the powers and functions of the SEC, providing for regulation of business ethics by an agency of the state; or providing for regulation by the businessmen themselves through their own association or associations which would have power over their members comparable to the power of an exchange. Congress, explicitly recognizing the choice, chose the latter alternative.⁵⁰

When the Maloney Act was adopted, it was hoped by some that a number of different affiliated associations would appear, including groups specializing in particular types of securities⁵¹ or organized on a regional basis.⁵² This did not happen. Only one association has been registered under the Act, the nationwide National Association of Securities Dealers,⁵³ which was formed and incorporated in response

⁴⁶ SEC, TENTH ANN. REP. 44 (1944).

⁴⁷ SEC, FOURTH ANN. REP. 32-33 (1938).

⁴⁸ See *Hearings before the Senate Committee on Banking and Currency on S. 3255*, 75th Cong., 3d Sess. 36-37 (1938).

⁴⁹ PSI Case, Release No. 3700, June 11, 1945 (see p. 61, n. 8, of the Release). There was strong industry support for the legislation. 83 CONG. REC. 4451 (1938); *Hearings before the House Committee on Interstate and Foreign Commerce on S. 3255 and H. R. 9634*, 75th Cong., 3d Sess. 6 (1938). One reason for industry support was the feeling that the SEC tended to favor the organized exchanges "at the expense of the unorganized markets." Comment, 48 YALE L. J. 633, 649 (1939). Such a tendency might well be inevitable with no effective regulation in the over-the-counter market. See also SEN. REP. NO. 1455, 75th Cong., 3d Sess. 2-3 (1938), and H.R. REP. NO. 2307, 75th Cong., 3d Sess. 3-4 (1938).

⁵⁰ SEN. REP. NO. 1455, *supra*; H. R. REP. NO. 2307, *supra*, at 4. See LOSS, SECURITIES REGULATION 762 *et seq.*; Comment, 48 YALE L. J. 633 (1939); PSI Case, Release No. 3700, June 11, 1945 (see p. 61, n. 8, of the Release). There was no opposition to the legislation in Congress. 83 CONG. REC. 4447-4461, 9444-9446 (1938).

⁵¹ SEC, FIFTH ANN. REP. 58 (1939).

⁵² Comment, 48 YALE L. J. 633, 649 (1939).

⁵³ DeWitt Investment Company, Release No. 4076, April 14, 1948 (see pp. 7-8 of the Release).

to the adoption of the Maloney Act. In considering the provisions of the Act, therefore, we may consider it as though it were simply a provision for and regulation of the NASD.⁵⁴

The Maloney Act provides that the association may be registered with the SEC.⁵⁵ To be registered, it must appear to the SEC that the NASD's rules provide that any broker-dealer dealing in securities otherwise than on an exchange *may* become a member of the NASD unless he falls in specified disqualified classes.⁵⁶ Those classes include, among others, persons who are suspended or expelled from an exchange or from the NASD for conduct inconsistent with just and equitable principles of trade. A person in a disqualified class may be admitted to membership only if the SEC directs or approves.⁵⁷ The NASD's rules must also assure fair representation of its members in the adoption of its rules and in the administration of its affairs.⁵⁸ Its rules must be designed to prevent fraud, to promote just and equitable principles of trade, to prevent unreasonable profits or charges, and to promote a free market; and they must not be designed to permit unfair discrimination, to fix minimum profits or charges, or to impose any schedule of prices.⁵⁹ The rules must also provide for disciplining of members for their violation.⁶⁰ Disciplinary proceedings must be fair, with notice and hearing.⁶¹

The Act further provides that if any disciplinary action is taken by the NASD, or if an application for membership is denied, such action shall be subject to review by the SEC upon its own motion or upon application by an aggrieved person. Pending such review, the NASD action is stayed.⁶² Rules adopted by the NASD from time to time must be filed with the SEC and may be disapproved by it.⁶³ The SEC may suspend or revoke the registration of the NASD if it is found to have failed to enforce compliance with its own rules or engages in any activity tending to defeat the purposes of the Maloney Act.⁶⁴ Likewise the SEC may suspend or expel from the NASD any member found to have violated the Securities Exchange Act or to have willfully violated the Securities Act.⁶⁵

The teeth of the Maloney Act appear in subsections (i) and (n) of Section 15A. The former permits the NASD rules to provide that no member shall deal with a non-member "except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." Subsection (n) provides that if there is any conflict between the Maloney Act and any other law of the United States in force on the date the Maloney Act took effect, then the Maloney Act "shall prevail." Thus it is provided that, despite

⁵⁴ The Maloney Act and the NASD are fully discussed in Loss, *SECURITIES REGULATION* 762-784. See also Grant, *The National Association of Securities Dealers: Its Origin and Operation*, [1942] WIS. L. REV. 597; Cherrington, *National Association of Securities Dealers*, 27 HARV. BUS. REV. 741 (1949). Cf. Lesh, *Over-the-Counter Brokers and Dealers*, 59 HARV. L. REV. 1237 (1946).

⁵⁵ Sec. 15A(a).

⁵⁶ See p. 530, *infra*.

⁵⁷ Sec. 15A(b)(3), 15A(b)(4). See Loss, *SECURITIES REGULATION* 774-775.

⁵⁸ Sec. 15A(b)(5).

⁵⁹ Sec. 15A(b)(7).

⁶⁰ Sec. 15A(b)(8).

⁶¹ Sec. 15A(b)(9).

⁶² Sec. 15A(g); see *infra* p. 534.

⁶³ Sec. 15A(j); cf. §15A(k).

⁶⁴ Sec. 15A(1); cf. §15A(3).

⁶⁵ Sec. 15A(2). See Loss, *SECURITIES REGULATION* 782.

antitrust laws,⁶⁶ the NASD may adopt rules requiring its members to deny dealers' and other concessions to non-members. The NASD has adopted such rules. Therefore, if a broker-dealer wishes to participate in an underwriting or otherwise to enjoy concessions which, generally, are necessary to any substantial over-the-counter business, he must be an NASD member and maintain himself in good standing. An exchange is able to exercise power because of the value of having access to a seat on the exchange. The NASD is able to exercise power in the over-the-counter business only because of the foregoing privilege to deny concessions to non-members.⁶⁷

The NASD functions through a national Board of Governors which has the power to adopt rules of ethics subject to ratification by a majority vote of the members voting, provided that a majority of the members vote. Disciplinary proceedings are initiated by committees in the various local districts of the NASD, called District Business Conduct Committees, whose decisions are subject to review by the Board of Governors either upon the initiative of that Board or upon appeal by a disciplined member.

Curiously, the Maloney Act made no specific provision for the exercise of power by the NASD over officers or employees of members. The defect was remedied by an adoption of rules, by the NASD, several years after it was organized, which provide, in effect, that every officer or partner of a member, and any employee of a member who is in a position of responsibility or who deals with the public, must become a "registered representative" with the NASD, and that the NASD shall have the same power over a registered representative as over a member. By a somewhat strained, but practical, course of reasoning the SEC sustained the validity of this rule under the Act and found that it would have the same power to review NASD disciplinary action with respect to registered representatives as it has with respect to NASD members.⁶⁸

⁶⁶ *Chamber of Commerce of Minneapolis v. FTC*, 13 F.2d 673 (8th Cir. 1926); *cf. Moore v. New York Cotton Exchange*, 270 U. S. 593 (1926).

⁶⁷ Comment, 48 *YALE L. J.* 633, 644-646 (1939). One firm whose NASD membership was temporarily suspended alleged that a fourth of the business "it would ordinarily do" could not be done while suspended from the NASD. *E. H. Rollings & Sons, Inc.*, Release No. 3683, April 18, 1945. NASD membership is essential to participate in underwritings and distributions. *PSI Case*, Release No. 3700, June 11, 1945 (see p. 20 of Release). See also *Sherman Gleason*, 15 S.E.C. 639, 654 (1944); *Lawrence R. Leeby*, Release No. 3898, Jan. 6, 1947 (see p. 4 of Release); *Dewitt Investment Company*, Release No. 4076, April 14, 1948 (see p. 8 of Release); *Loss*, *SECURITIES REGULATION* 769-770. There is no doubt that Congress meant that the NASD's power to boycott should be a real sanction, quite like an exchange's power to expel a member; its committees said: "... it is contemplated that exclusion from membership in a registered securities association will be attended and implemented by economic sanctions. In this respect, exclusion from such an association would be comparable in effect to expulsion from a national securities exchange. It is these economic sanctions which would make possible effective discipline within the association." SEN. REP. NO. 1455, 75th Cong., 3d Sess. 8-9 (1938), H. R. REP. NO. 2307, 75th Cong., 3d Sess. 9 (1938).

⁶⁸ *Re NASD*, Release No. 3734, Sept. 19, 1945. The SEC's reasoning by which it found that it would have such review power raises some difficult and technical questions beyond the scope of this article. See *Loss*, *SECURITIES REGULATION* 768. However as to the reasonableness of the NASD's assertion of power over registered representatives there could be no doubt. Thus it was pointed out by the SEC that salesmen involved in misconduct while employed by one NASD member might switch their employment "and attempt to carry on the same practices in their new employment" (see p. 3 of Release No. 3734).

The NASD registered with the SEC in 1939.⁶⁹ There have been only about twenty-five cases where the SEC has been called upon to pass on any NASD rule-making, disciplinary, or membership action. But in that body of precedent we find an instructive treatment of the problem of integrating the social controls of a private agency with those of the state.

In the first place, there must be a considerable degree of cooperation between the NASD and the SEC. The SEC, occupied with a wide range of complex problems, frequently invites the advice and the assistance of the NASD in the formulation of policies and administrative measures affecting the over-the-counter business. In addition, the SEC has from the beginning referred to the NASD disciplinary matters which come to its attention.⁷⁰ Thus when its examiners uncover evidence of conduct violating the NASD rules the SEC may refer such violations to the NASD for its consideration.⁷¹ Such references do not always result in action; nor does it follow that a reference which is acted upon necessarily results in an NASD determination that there has been a violation. The NASD has functioned with striking independence, and has resolutely resisted any tendency to become a mere arm of the SEC.⁷²

This raises a fundamental question. Does the NASD, and the body of rules or "law" it adopts and administers, derive force from the state; or is it, like the exchanges, a purely private organization, subject to the restraints of the state only when it oversteps bounds? The question appears academic; but on occasion it may be important in the resolution of specific issues. In one of its most important cases, in the course of its argument to the SEC, the NASD urged that it derived its powers from the law of the state of its incorporation, like any other private corporation, and that its action should be reviewed on that premise rather than as though it were carrying out some power delegated by Congress. One of the Commissioners insisted that, if the SEC affirmed the NASD decision, a governmental sanction would be added to the decision of the NASD. Thus, he concluded, the NASD rules "have ceased to be merely private rules of conduct for members of a private association. They have become, in addition, the primary standards to guide decisions of an agency of the government in carrying out a statutory responsibility."⁷³

Here there is suggested a very vital consideration, though one rarely touched upon in the SEC opinions dealing with the NASD. Congress, in the Maloney Act, determined that it wished to rely upon the processes of a private agency to exercise social control; in effect, it determined that a state agency operating in the field in question was too unwieldy, expensive, and awkward. Does it follow that, in the exercise of its functions, the private agency is to be treated as though it were a completely private agency, subject only to the specific restraints spelled out by the

⁶⁹ *Re NASD*, 5 S. E. C. 627 (1939).

⁷⁰ See Loss, *SECURITIES REGULATION* 781-782.

⁷¹ SEC SIXTH ANN. REP. 109-110 (1940); SEC FIFTEENTH ANN. REP. 61 (1949).

⁷² Cf. Loss, *SECURITIES REGULATION* 783.

⁷³ PSI Case, Release No. 3700, June 11, 1945 (see p. 49 of the Release; see also p. 14 n. 17).

Congress; or is it to be treated as though it were itself an agency of government, importing the procedural and substantive standards which usually are applicable to government action? The value of having a private agency could be destroyed if it were required to function according to the same standards and with the same formality as apply in the case of a state agency.⁷⁴

Fundamental to the operation of the NASD is its democratic character.

An exchange probably can deny membership to anyone—just as can an ordinary club.⁷⁵ Although theoretically this springs from the physical limitations of an exchange, in practice what it means is that there is an effective restraint upon the number of competitors who may operate in the exchange market. However like an exchange the NASD was intended to be, the SEC has been alert to forestall in the NASD any trace of this fundamental characteristic of an exchange.⁷⁶ With some justification the NASD interpreted the Act as permitting it to deny membership to one who was not “regularly engaged in the business of broker and dealer,” and had so provided in its bylaws. On that ground it denied membership to one who had the mere shell of an office and in the course of several years had effected a total of only seven securities transactions with customers. The SEC reversed. The Act, it insisted, meant that membership must be open to all, save those specifically disqualified. The “quantitatively limited” extent of an applicant’s business could be no bar; the SEC emphasized the fact that the NASD is the only association organized under the Act and pointed out that membership in it is necessary to “expansion in various branches of the business.” If, said the SEC, lack of patronage or financial success were to be a bar to membership, then only those “already on the scene” would be able to enjoy the benefits of NASD membership.⁷⁷

In another connection the SEC reached the same conclusion in an even closer case. When the NASD was first registered, the SEC had approved registration with a caveat that there should be some requirement to secure the solvency of its members “lest the public be misled into thinking that membership . . . in any way connotes solvency.”⁷⁸ Later the NASD adopted a bylaw amendment providing

⁷⁴ Compare pp. 534-540, *infra*. The speed with which the NASD acts in the disposition of disciplinary proceedings is remarkable. The record, in the case of the 71 complaints most recently disposed of, as of January 1, 1952, shows an average time of 6.2 months from the filing of the complaint until final disposition. Of the 71 cases, 62 were finally disposed of at the District level; their average time from the filing of complaint to disposition was 5.6 months. In the case of the 9 which were reviewed by the Board of Governors, the average time from initiation in the District to disposition by the Board was 10.1 months. These figures have been computed by us from data supplied by the NASD.

⁷⁵ Testimony of Commissioner Mathews, in *Hearings before the Senate Committee on Banking and Currency on S. 3255*, 75th Cong., 3d Sess. 7 (1938). *Chas. F. Garrigues Co. v. New York Produce Exchange*, 213 App. Div. 625, 211 N. Y. Supp. 13 (1st Dep’t 1925).

⁷⁶ See *LOSS, SECURITIES REGULATION* 776.

⁷⁷ *Dewitt Investment Company*, Release No. 4076, April 14, 1948. In the same case the SEC held that expulsion from an exchange prior to the adoption of the Securities Exchange Act did not constitute a disqualification from NASD membership, although the Maloney Act provided that one could not be accepted by the NASD, without SEC approval, if he had been expelled from an exchange. The point decided was a narrow one of statutory interpretation, but the decision illustrates the SEC’s expansive view of the right to join the NASD. *But cf.* *J. A. Sisto & Co.*, 7 S. E. C. 1102, 1103 (1940).

⁷⁸ *Re NASD*, 5 S. E. C. 627, 632 (1939).

that a member should have a specified minimum net capital, and the amendment was submitted to the SEC. After a hearing, as required by the Act, at which several NASD members appeared in opposition, the SEC rejected the amendment as being inconsistent with the Act.⁷⁹ Although the amendment had been informally discussed with the SEC prior to its adoption, and had been viewed "favorably" by the SEC, upon reflection the SEC determined that it could not be squared with the Act because it would exclude persons from membership solely because of the size of their capital.⁸⁰

Dicta in these decisions, considered apart from the language of the Act, leave room for argument that the NASD could use its power to refuse membership as a means for assuring responsibility among over-the-counter broker-dealers. Thus, in referring to the legislative history of the Act, the SEC quoted language to the effect that anyone "who is willing to conduct his business decently" should be eligible.⁸¹ And in the *DeWitt* case^{81a} it pointedly recognized the importance of maintaining high standards in the business. But the language of the Act itself is sweeping.⁸² One can only observe that, unless an agency such as the NASD can screen applicants to some extent, at least under governmental supervision, it lacks a most effective instrument for accomplishing its mission.⁸³

Not only must NASD membership be broadly available, but the processes of democracy are assured in NASD rule-making. The Act requires that there be

⁷⁹ *Re* NASD, 12 S. E. C. 322 (1942).

⁸⁰ *Id.* at 325, 326. According to the SEC's opinion, the effect of the NASD rule would have been drastic; it might have resulted in expulsion of more than a quarter of the NASD membership. The SEC stated that a specific requirement for minimum capital was rejected by the Senate Committee during the consideration of the Maloney Act. *Id.* at 325-326. Recognizing that there was need for an assurance of solvency of over-the-counter broker-dealers, after this mistaken step by the NASD the SEC announced that it would itself propose its own rule requiring maintenance of a specified ratio between indebtedness and capital, modeled upon a similar rule written into the Act with respect to exchange members, which would not make mere size of capital decisive. *Id.* at 327, 329.

⁸¹ *Id.* at 325.

^{81a} *Supra* note 77.

⁸² See p. 527 *supra*. Nonetheless the legislative committees explained the Act as requiring that all "who conduct an honest and responsible business shall be eligible for membership. . . ." SEN. REP. NO. 1455, 75th Cong., 3d Sess. 6 (1938); H. R. REP. NO. 2307, 75th Cong., 3d Sess. 6-7 (1938).

⁸³ When one in the disqualified categories specified in the Act seeks admission or readmission to the NASD there is no doubt of the power—indeed the duty—of the NASD to scrutinize the applicant with care. The controlling partner of J. A. Sisto & Company was expelled from the New York Stock Exchange in 1938, making the firm ineligible for NASD membership. In 1944, when it sought such membership, the NASD took favorable action, subject to SEC approval, upon a record which consisted merely of the firm's application and related correspondence. The record, in this state, showed nothing but the passage of time. The SEC refused approval, stating that: "An applicant within the exclusionary categories . . . is under a duty to present facts to justify its admission to membership. . . . If an applicant cannot demonstrate fitness to exercise the responsibilities and to enjoy the benefits of membership . . . the purpose of the statute would be contravened if we directed or approved its membership." J. A. Sisto & Co., Release No. 3614, Nov. 1, 1944 (see pp. 3-4 of the Release). See also J. A. Sisto & Co., 7 S. E. C. 647, 1102 (1940). Several years later the NASD developed a record and again recommended acceptance of membership. This time, the SEC observed that the mere passage of time would require a fresh review of the circumstances. It reviewed the facts brought out before the NASD with respect to the firm's good conduct during the years since its earlier faulty conduct, and approved the NASD's determination. J. A. Sisto & Co., Release No. 4142, July 29, 1948.

"fair representation of its members in the adoption of any rule."⁸⁴ The NASD bylaws require that its rules of ethics be ratified by vote of its members. Originally this vote was conducted by open ballot. In passing upon a rule to which there was considerable opposition within the membership, the SEC remarked that "as a matter of hindsight" it would seem that "a secret ballot would have been preferable."⁸⁵ And even after a secret ballot procedure was adopted, the SEC has remarked that "it seems reasonable to assume" that opponents of a rule could have representatives present at the tallying.⁸⁶

The SEC has likewise indicated some tendency to emphasize the autonomy which District Business Conduct Committees enjoy under the NASD bylaws.⁸⁷ The bylaws permit the Board of Governors to issue interpretations of the rules, and in one notable instance the Board adopted an elaborate interpretation to the effect that unreasonably high prices charged a customer would be deemed inconsistent with just and equitable principles of trade, inviting attention to the fact that a survey showed that no more than a 5 per cent profit or mark-up was made by members in the great majority of their transactions. This interpretation was followed by a letter from the Chairman of the Board and the Executive Director of the NASD to the various District Business Conduct Committees strongly implying that Committees should bring proceedings against a member in any case where a profit of more than 5 per cent was secured. In the course of discussing the legal effect and justification of this letter, the SEC remarked: "The institution of formal proceedings against members is a local matter, and the committees are free to apply their own judgment for determining when to bring disciplinary proceedings."⁸⁸

However great the power of the NASD, therefore, the organization has a strongly democratic character. Membership cannot be restricted. Membership control of rule-making is assured, with emphasis upon the secret ballot. And there is substantial local autonomy in determining whether disciplinary measures are to be instituted.

Equally fundamental is the insistence of the Act and the SEC that the NASD actually enforce its rules. The Act requires that there be rules governing business ethics which must provide that the members "shall be appropriately disciplined, by expulsion, suspension, fine, censure, or any other fitting penalty, for any violation" of the rules.⁸⁹ The SEC is empowered by Section 15A(1)(1) to suspend or revoke the NASD's registration if it finds that the NASD has "failed to enforce compliance with its own rules. . . ."⁹⁰ Although the SEC has never had occasion to

⁸⁴ Sec. 15A(b)(5).

⁸⁵ *Re NASD*, 12 S. E. C. 322, 323 (1942).

⁸⁶ *Re NASD*, Release No. 3734, Sept. 19, 1945 (see p. 15 of the Release).

⁸⁷ *Cf.* Comment, 48 *YALE L. J.* 633, 649 (1939).

⁸⁸ *Re NASD*, 17 S. E. C. 459, 468 (1944).

⁸⁹ Sec. 15A(b)(8).

⁹⁰ In this respect the Act imposes a stricter—or at least a much plainer—duty on the NASD than on stock exchanges. *Cf.* p. 525 *supra*.

It is also significant that the *duty* to adopt and enforce rules has not been imposed in other cases where Congress has provided for a certain amount of self-government. Steamship companies, airlines, and railroads are *privileged* to varying extents to adopt agreements, free of antitrust restraint, which

take any action implementing this duty, it has evidenced unmistakably that it is alert to the NASD's responsibility and that it would not be likely long to tolerate any tendency on the part of the NASD to slight its enforcement function. It is very clear that the NASD is not a mere trade association or service agency.⁹¹

At the very outset, when the NASD applied for registration under the Act, it had no plans for a paid investigatory staff; apparently, initially, it contemplated the possibility of relying entirely upon voluntary committees to administer its rules. Of this the SEC pointedly observed that "it would appear doubtful whether effective enforcement of the association's rules of fair practice could be secured" and that a paid staff would be necessary.⁹² Pointed also was the SEC's comment on the proposed schedule of dues; it remarked that they did not seem enough "to enable the association to perform the task of cooperative regulation, which naturally includes adequate self-policing, except to a limited extent" and it proposed to scrutinize the NASD's record closely.⁹³ In its Annual Report for the next year, the SEC noted: "The investigations of complaints conducted by local business conduct committees of the association have been followed with especial care."⁹⁴ And in the following year the SEC noted that the NASD would be in a position to conduct "its own investigations in a greater number of instances, since it increased its paid staff materially," and spoke approvingly of the NASD's abandonment of a policy of taking action only when complaints came to it in favor of a policy of taking the initiative in the investigation of its members and the institution of complaints; this, said the SEC, was "a distinct step forward" and "should prove of real assistance to the Commission in meeting its problem of policing the . . . over-the-counter houses scattered throughout the land."⁹⁵ In its Annual Reports the SEC has included data indicating the disposition by the NASD of disciplinary matters referred to it by the SEC staff.⁹⁶

In short—and this is a point which has been deeply impressed upon the NASD and its leadership, if not upon all of its members—the Maloney Act is not merely a grant of an opportunity for self-government; though the over-the-counter houses were not *required* to form the NASD, once formed it *must* govern. As long as the NASD is adhered to by a sufficient number of the over-the-counter houses to make

provide a limited self-regulation in those industries; but in providing such a privilege Congress imposed no such duty to govern as it has imposed on the NASD. Shipping Act of 1916, Sec. 15, 39 STAT. 733 (1916), as amended, 46 U. S. C. §814 (1946); Civil Aeronautics Act of 1938, Secs. 412, 414, 52 STAT. 1004 (1938), as amended, 49 U. S. C. §§492, 494 (1946); and the Bulwinkle-Reed Act of 1948, 62 STAT. 472, 49 U. S. C. §5b (Supp. 1951).

⁹¹ This is not to say that the NASD does not engage in many service functions. Its service functions, indeed, are more extensive than in the case of the usual trade association. They include provision of a voluntary arbitration service, provision of a group insurance plan for members and their employees, nationwide dissemination of daily quotations or price ranges of unlisted securities, publication of a trade paper, liaison with government agencies, and other services.

⁹² *Re* NASD, 5 S. E. C. 627, 628 (1939).

⁹³ *Id.* at 631.

⁹⁴ SEC, SIXTH ANN. REP. 109 (1940).

⁹⁵ SEC, SEVENTH ANN. REP. 152-153 (1941).

⁹⁶ *E.g.*, SEC, FIFTEENTH ANN. REP. (1949).

it economically necessary for broker-dealers to become and remain NASD members, the business has no choice but to subject itself to its own policing.

The SEC's emphasis upon the NASD's duty to adopt and enforce a code of ethics quite naturally raises the question of the extent to which the SEC will accept the NASD's decisions. Sec. 15A(k) empowers the SEC to abrogate any NASD rule if abrogation is appropriate "to protect investors." Moreover, any NASD rule must be filed with the SEC to take effect thirty days thereafter unless disapproved by the SEC as inconsistent with the statutory mandate that the association's rules be designed "to protect investors and the public interest."⁹⁷ It is likewise provided that any disciplinary action taken by the NASD shall be subject to review by the SEC upon petition of an aggrieved party or on the SEC's initiative. Review includes the record before the NASD "and such other evidence as it [the SEC] may deem relevant" and is to be directed to the questions (a) whether the disciplined person committed the wrong of which he was found guilty, (b) whether the act committed was a violation of the NASD rule designated "in the determination of the association," and (c) whether the penalty imposed was "excessive or oppressive."⁹⁸

Without getting into the technicalities of the statutory language providing for this review, it is obvious that it is important to know whether the SEC review is completely *de novo*. Analogies suggest themselves: the extent of the review by an appellate court of a trial court's decision and the extent of the review by a court of the action of an administrative body. The extremely limited court review of the discipline imposed by exchanges has already been noted.⁹⁹

There is some evidence that the SEC recognizes a kind of presumption in favor of the NASD's judgment with respect to the exercise of its rule-making function. Section 22 of the Investment Company Act of 1940 provided that an association registered with the SEC under the Maloney Act—meaning the NASD—could adopt certain rules in accordance with the Maloney Act regulating dealings by its members in investment company shares. It was further provided that, after the lapse of one year, the SEC could adopt regulations governing the same subject. The NASD did adopt elaborate rules which were duly filed with the SEC. In permitting them to go into effect, the SEC announced that it was not called upon to imply "in any way that they are adequate to solve the problems to which they relate."¹⁰⁰ And, in discussing certain objections which had been made on the ground that one of the rules would discriminate against some dealers, the SEC stated that it was not clear that there would be unfair discrimination, and added, ". . . as it stands the effect of the rule is doubtful and we feel that under the circumstances the doubt should be resolved in favor of the viewpoint of the Association."¹⁰¹ (In fact, the NASD's rules are still in force and the SEC has never adopted rules of its own.)

It was apparent, of course, that in the Investment Company Act the Congress

⁹⁷ Sec. 15A(j).

⁹⁸ Sec. 15A(g), (h).

⁹⁹ See pp. 519-522 *supra*.

¹⁰⁰ *Re NASD*, 9 S. E. C. 38, 43 (1941).

¹⁰¹ *Id.* at 45.

meant to give the industry a chance, through its own association, to regulate itself.¹⁰² But the same intention was evident in the Maloney Act itself,¹⁰³ and the Investment Company Act made the NASD rules subject to all the provisions of the Maloney Act. Hence the SEC's views expressed in this instance should be applicable to any other rule adopted by the NASD.

Thus far there has been no evidence of a presumption in favor of the NASD in SEC opinions reviewing NASD disciplinary action against its members. In an individual opinion by one of the Commissioners there is a note that he does not believe that the SEC is bound by the findings of fact made by the NASD.¹⁰⁴ Yet in commenting upon the function of the disciplinary tribunals of the NASD the SEC has been at pains to state that,¹⁰⁵

... the proceeding is heard by the accused member's fellow businessmen who are supposed to bring their knowledge of trade practices to bear upon the case, and make their determination in the light of their experience as technicians in the securities markets rather than as lay jurors or legalistic judges.

... trade practice cases within the NASD are heard by the accused member's fellow businessmen who are supposed to approach each case as experienced members of the trade, familiar with its problems and practices.

If this is true—and the statement reflects very clearly the congressional purpose in adopting the Maloney Act¹⁰⁶—there must be an “expertise” in the NASD to be given effect by the SEC through a presumption akin to that lent by a court to the expert determination of an administrative body. Failure of the SEC thus far to articulate such a presumption is probably due to the absence of occasion therefor rather than to any reluctance to do so. Indeed there have been several cases where the SEC obviously was relying upon the NASD's judgment, instead of exercising its own independently, in situations quite like disciplinary proceedings. Under the Act, where a broker-dealer is in a disqualified category because of a previous ex-

¹⁰² *Id.* at 42; SEC, SEVENTH ANN. REP. 153-154 (1941).

¹⁰³ When the NASD was about to be organized the SEC commented, “In order that every reasonable opportunity may be afforded such association or associations as may become registered with the Commission to exercise as broad a regulatory function as possible, the Commission has refrained from any substantial amplification of its own rules for regulation of over-the-counter markets.” SEC, FIFTH ANN. REP. 58 (1939).

¹⁰⁴ PSI Case, Release No. 3700, June 11, 1945 (see p. 65 n. 13 of the Release). Compare Stewart, Release No. 3720, Aug. 7, 1945, where the SEC sustained disciplinary action taken by the NASD. Its opinion states that: “Our findings are based upon an independent review of the record, which includes the record developed in the proceedings before the NASD.” See also, R. H. Johnson & Co., Release No. 4694, April 2, 1952 (see p. 2 of the Release).

¹⁰⁵ *Re* NASD, 17 S. E. C. 459, 468, 470 (1944).

¹⁰⁶ See remarks of Senator Maloney, 83 CONG. REC. 4451 (1938). In his testimony before the Senate Committee on Banking and Currency on S. 3255, where he was presenting the case in support of the Maloney Act, Commissioner Mathews observed: “. . . even if the funds were furnished for a direct government regulatory program, and even if an adequate staff were provided, and even if there were no problems of securing enforcement through the courts . . . a great many of the abuses in the securities business are not matters of definite illegality; they are matters of ethics. . . . There is a vast field for the control of ethical practices in this business, *which is not a field which the Government can very well occupy*” (italics supplied). *Hearings before the Senate Committee on Banking and Currency on S. 3255*, 75th Cong., 3d Sess. 10 (1938).

pulsion from the NASD or otherwise, he cannot be accepted as an NASD member without approval or direction by the SEC; similarly, a person who seeks to become a registered representative of a member, but who is under a similar disqualification, cannot become such without SEC action. Ordinarily, there is first an application to the NASD in such cases. Where the NASD makes a record on the case, and does exercise its judgment upon that record, the SEC's opinions indicate a strong tendency to accept the NASD's judgment.¹⁰⁷

Certainly there is nothing in the Act that *requires* the SEC to exercise its judgment *de novo*. It is true that on appeal to the SEC in a disciplinary proceeding the Act provides that it may receive additional evidence,¹⁰⁸ but it does not follow that in a doubtful case either of fact or of principle the SEC is to decide a proposition as though the NASD had not spoken.¹⁰⁹ Especially is this true with respect to the question whether the penalty imposed by the NASD should be sustained; in fact the Act seems to contemplate a very considerable measure of discretion in the NASD on that issue, for the SEC's function is to determine whether the penalty is "excessive or oppressive"—not to determine what it would have done on its own.

Support for the view that the SEC should resolve doubts in favor of the NASD's judgment is to be found in its insistence that the NASD actually hear and determine cases and that evidence be presented in the first instance to the NASD—a doctrine similar to that applied by the courts in reviewing administrative action. This doctrine almost necessarily implies the view that, where the administrative agency has heard and decided on the evidence, its judgment is not to be reviewed *de novo* in court.

In one case, involving an expelled member's application for reinstatement, the NASD had denied the application without any statement of its reasons. In overruling the NASD, the SEC stated that, while the NASD had "complied with the formal mechanics" of procedure, "its action lacks the very essence envisaged by the statutory procedure, namely, an informative statement of its reasons. . . ." The SEC added:¹¹⁰

If the NASD is to fulfill the responsibility imposed upon it by the statute and if its decisions are to serve as an aid to us in determining what action to take, they must be based on findings which state plainly the reasons for the NASD's action.

¹⁰⁷ This is reflected in some such phrase as, "After consideration of all the circumstances, and giving due weight to the recommendation of the NASD. . . ." O. H. Hecht, Release No. 4562, Feb. 2, 1951. See also William L. Johnsen, Release No. 4116, July 13, 1948; H. L. Ruppert and Joseph H. Lynch, Release No. 4117, July 13, 1948; J. A. Sisto & Company, Release No. 4142, July 29, 1948.

¹⁰⁸ Compare pp. 537-538, *infra*.

¹⁰⁹ Mr. Loss states that ". . . the Commission's review of the Association's action is broader than the judicial review of the Commission's action in that the Commission may review *de novo*, 'upon consideration of the record before the association and such other evidence as it may deem relevant.'" SECURITIES REGULATION 772-773. If Mr. Loss means that the Commission may review *de novo* in the sense that it may receive new evidence, then his statement and our statement are not in disagreement. But if he means that the Commission may review the NASD's findings and conclusions on the basis of a *de novo* appraisal of the record made before the NASD, then he is going further than the language of the Act requires—and he cites no authority except the language of the Act.

¹¹⁰ Lawrence R. Leeby, Release No. 3898, Jan. 6, 1947.

In another case, despite the fact that the NASD Board of Governors had given *de novo* review to disciplinary action taken by a District Committee, and had sustained such action, the SEC took cognizance of infirmities in the District Committee's procedure. It insisted that the decisions of such committees "ought to be supported not merely by peremptory conclusions, but by articulated findings and a reasoned consideration of the relevant facts of the case."¹¹¹ And in still another case, where a member was charged with excessive mark-ups to its customers, the SEC seems to have said that it found the NASD's opinion wanting in that it failed to disclose whether "consideration" was given by the NASD to certain evidence offered by the member which the member argued had a bearing upon the ethics of its conduct.¹¹²

Here then we find the SEC apparently insisting that the NASD actually make findings and disclose in a written statement that it has given consideration to the arguments advanced, whether or not it agrees with such arguments. While the precedents are sketchy, they suggest the elaborate body of doctrine built up by the courts with respect to the need for full findings from an administrative agency in cases where a hearing is required.¹¹³

Other requirements normally attaching to a hearing in the case of government agencies have been suggested in SEC opinions. Thus where it was contended that a District Committee had been "dominated" by its secretary, who had taken a dim view of the appearance of counsel before the Committee and in certain respects had run the Committee in a high-handed manner, the SEC commented:¹¹⁴

Business conduct committees, sitting in a quasi-judicial capacity, are in the difficult and vulnerable position of businessmen trying a competitor. Under such circumstances, they are bound to observe the highest standards of fair procedure. In so doing, they must not in any way discourage or abridge a respondent's exercise of any right which their rules afford or which simple justice demands, including the right to counsel. They should take every reasonable step necessary to insure that their deliberations are not affected by the personal prejudices of any of the participants in the proceeding.

Reflecting even more strongly the traditional view taken by the courts in reviewing action of administrative agencies is an opinion by the SEC in one case testing the provision of the Act that, on the SEC's review, it shall consider not only the

¹¹¹ *Sherman Gleason*, 15 S. E. C. 639, 648 (1944).

¹¹² *Herrick, Waddell & Co.*, Release No. 3935, Mar. 25, 1947 (see p. 11 of the Release). See also *Sherman Gleason*, 15 S. E. C. 639, 648-649 (1944).

¹¹³ In one rather curious case the SEC sustained a penalty which it felt not excessive for one violation, although the NASD itself had predicated the penalty upon that violation plus two others which the SEC found not to warrant punishment. *Sherman Gleason*, 15 S. E. C. 639, 650-651, 654 (1944). This suggests that the NASD might be upheld in some circumstances even if it gives the wrong reason for its action.

¹¹⁴ *Sherman Gleason*, 15 S. E. C. 639, 648 (1944). In the same case the SEC commented that two of the violations of which the respondent had been found guilty by the NASD had not been charged in the complaint filed against him. For other reasons, however, it held that these alleged violations did not warrant a penalty; the SEC did not determine the procedural question whether a finding of a violation may be sustained where the violation in question was not charged in the original complaint. 15 S.E.C. at 649-651.

NASD record but also "such other evidence as it may deem relevant."¹¹⁵ The case dealt with a finding by a District Committee that a member had been guilty of excessive mark-ups to its customers; the Board of Governors had affirmed by an evenly divided vote. Before the SEC, the member moved for permission to adduce evidence of its policy to make full disclosure of its mark-ups to its customers, showing what it had done in this respect since the occurrence of the alleged violations. The SEC held that evidence of what had been done after the alleged violations could not be relevant, but then proceeded with this revealing passage:¹¹⁶

The experience of our judicial system has demonstrated that, to the extent that review is limited to the record before the lower tribunal, there is more complete preparation by the parties, a clearer delineation of issues, and substantial simplification in the task of a review. Moreover, fairness to the original tribunal requires that it be given the opportunity to consider all available evidence in making its decision. In general, therefore, the Commission will not open the record to receive further evidence except in a case where it is shown that such evidence is relevant to the issues raised but could not be presented in the original proceedings.

And in the same case at a later stage, after the SEC had determined that the NASD had unduly limited the scope of its inquiry at its hearing, the SEC considered whether to take additional evidence and dispose of the case; it decided that the better course was that of remanding the case to the NASD for further proceedings.¹¹⁷

If, as these opinions indicate, the SEC attaches importance to an articulation of the reasons for the NASD's action, is insistent upon the guarantees of a "fair hearing," and will not let parties short-cut the NASD by withholding evidence until they reach the SEC, then a very strong presumption *should* attach to the NASD's action once it has been taken in accordance with the "due process" contemplated by

¹¹⁵ See p. 536, *supra*.

¹¹⁶ Herrick, Waddell & Co., Release No. 3831, July 11, 1946. Cf. J. A. Sisto & Co., Release No. 3614, Nov. 1, 1944. The statement quoted in the text finds support in the common-law rule governing the granting of new trials on the ground of newly discovered evidence. 39 AM. JUR. New Trial §§156-161. A motion for new trial on the ground of newly discovered evidence requires a showing of due diligence. FED. R. CIV. P. 59(a)(b), 60(b); 3 MOORE, FEDERAL PRACTICE §§59.02, 60.02 (1938). Administrative agencies require a similar showing. See, e.g., INTERSTATE COMMERCE COMMISSION RULES OF PRACTICE 101(b). Unless it finds a clear abuse of discretion, an appellate court will not reverse the denial of a new trial by a trial court, *Brown v. Schwartz*, 164 F.2d 151 (5th Cir. 1947); *United States v. Bransen*, 142 F.2d 232 (9th Cir. 1944); or the denial of a rehearing by an administrative agency, *ICC v. Jersey City*, 322 U. S. 503 (1944); *Lang Transportation Corp. v. United States*, 75 F. Supp. 915 (S. D. Cal. 1948); *Carolina Scenic Coach Lines v. United States*, 59 F. Supp. 336 (D. N. C. 1945), *aff'd*, 326 U. S. 680 (1945). New evidence not presented to an administrative agency will not be received by a court reviewing the agency's decision. *Tagg Bros. v. United States*, 280 U. S. 420, 443-445 (1930). Nor will an appellate court ordinarily consider new issues of fact or law on appeal from the decision of a lower court, *Duignan v. United States*, 274 U. S. 195, 200 (1927); *Friedman v. Decatur Corp.*, 135 F.2d 812, 813 (D. C. Cir. 1943); *Goldie v. Cox*, 130 F.2d 695, 715 (8th Cir. 1942); or of an administrative agency. *B. & O. R. R. v. United States*, 298 U. S. 349, 388-389 (1936) (concurring opinion by Brandeis, J.); *Carolina Scenic Coach Lines v. United States*, 56 F. Supp. 801, 804-805 (D. N. C. 1944), *aff'd*, 323 U. S. 678 (1944); *General Utilities & Operating Co. v. Helvering*, 296 U. S. 200 (1935); cf. *Hornel v. Helvering*, 312 U. S. 552 (1941).

¹¹⁷ Release No. 3935, Mar. 25, 1947 (see p. 12 of the Release). Compare a reviewing court's remand to an administrative agency to consider additional evidence. *New York v. United States*, 331 U. S. 284, 334-335 (1947).

the SEC.¹¹⁸ Were it otherwise, a great deal of money and time would be wasted by NASD process, and one might wonder what purpose is served by the Maloney Act.

There is another procedural problem, minor in scope but practically very important to administration of the NASD's affairs, which sheds light upon the NASD's special character. That is the problem of publicity. Traditionally exchange proceedings against exchange members are secret; the exchanges generally have been very insistent that their linen be washed wholly within the family. The same thing is usually true of all private organizations. But with the nexus between NASD disciplinary proceedings and government review thereof, there arises the question of publicity at the stage of an SEC appeal. The problem is sometimes perplexing, for, under the Act, a disciplined member has a right to an appeal and, since the NASD order is automatically stayed pending such an appeal, the SEC action is really an integral part of the NASD process.

In its own affairs, the NASD preserves secrecy, unless the Executive Committee of the Board of Governors decides otherwise in a given case, until there has been a final NASD determination. At that point the action is announced, even though the disciplined member appeals to the SEC. Sometimes there are cases, however, where it seems desirable to preserve privacy through the SEC stage. On the only occasions when the question has arisen, the NASD and the members concerned have agreed on the point, and the SEC has cooperated. The question can become acute when, after an individual has suffered disqualification, approval is sought of his employment as a registered representative by a firm with which he was not connected when his trouble arose. The new firm might hesitate to offer an employment opportunity if its identity were to be publicly known. In such cases the SEC has fashioned a procedure to permit prosecution of the matter without public disclosure of the name of the new employer.¹¹⁹ However, in a disciplinary case, where serious charges are being reviewed by the SEC, privacy may not be consistent with

¹¹⁸ The reader will observe that we have skirted a problem of some difficulty and of considerable interest. If the NASD determinations are given some presumptive weight—leaving aside the question whether it might be a presumption exactly like that applied by a court to an administrative agency's determinations—would it follow that the NASD's process must meet the requirements of constitutional due process of law? In such circumstances would the constitutional requirements applicable to the NASD be the same as those applicable to a state agency? If, on the other hand, the NASD judgments are given no presumptive weight at all, with completely *de novo* review by the SEC, then why should the SEC ever be concerned about procedural or other defects in the NASD process? None of these questions has been considered in the SEC opinions. There is one dictum which assumes that a hearing by an exchange in a disciplinary case, being "private action," is not a "hearing under the safeguards provided by due process of law." *J. A. Sisto & Co.*, 7 S. E. C. 647, 653 (1940). *Cf.* pp. 530-531, *supra*. This dictum would not necessarily apply to a hearing before the NASD. If the state attaches consequences to the action of a private body which affect property and personal rights—consequences not voluntarily assumed by the person affected—the mere fact that the action in question is private instead of state agency action does not mean that constitutional safeguards cannot be applied to the processes of that private body. *Cf. Steele v. Louisville & N. R. R.*, 323 U. S. 192, 198 (1944); *Edwards v. Capital Airlines*, 176 F.2d 755, 760-762 (D. C. Cir. 1949). Quære whether constitutional due process might be imported into the exchange's procedures by virtue of consequences attached by the Securities Exchange Act of 1934 to expulsion from an exchange.

¹¹⁹ Edward E. Trost, Release No. 3955, April 29, 1947. See LOSS, *SECURITIES REGULATION* 780.

the public interest. The question received some attention in one case where, on its own initiative, the SEC reviewed 6 typical cases out of some 70 cases in which the NASD had disciplined members for failure to abide by price maintenance provisions of an underwriting syndicate. The 6 were picked merely as types, and it was felt that it would be unfair to these 6 members to disclose their identity. The SEC agreed to proceed on a "John Doe" basis. But it warned that it could not assure a similar course in future cases where it might be necessary to summon as witnesses the persons who had been disciplined.¹²⁰

Administrative agencies not infrequently make provision for confidential treatment of portions of proceedings before them, and in some of its work the SEC itself has permitted proceedings to be private until their conclusion. But "John Doe" proceedings, wherein the identity of the party is never disclosed, present obvious dangers. Even the preservation of privacy while a proceeding is pending is not lightly to be permitted. There are possibilities not only of abuse but of fostering the unhealthy attitude that the matter is of concern only to the SEC and the individual directly involved. Even while the proceeding is pending within the NASD, the virtues of washing linen privately, great as they often are, do not always outweigh considerations arguing publicity.¹²¹

In the area of the substantive "law" applied by the NASD, the most significant problems encountered by the SEC have been in cases where the application of principles of ethics verges upon outright regulation of the economics of the business.

A most obvious ethical problem is presented by excessive charges to customers. Customers are often either in no position to have information as to fair prices or are so unsophisticated as to be at the mercy of their broker-dealers. Nonetheless the Maloney Act provides that the NASD rules shall not "impose any schedule of prices."¹²² The NASD thus far has dealt with the subject of fair prices only in general terms; its rules simply require its members to conduct themselves honorably and to make charges bearing a fair relation to the market and to other relevant circumstances.

Obviously some mark-ups might be so gross as to constitute fraud. Even short of fraud, some mark-ups might be so high as to be unethical on their face.¹²³ The difficulty comes when a mark-up falls within the zone between the clearly ethical

¹²⁰ PSI Case, Release No. 3700, June 11, 1945 (see p. 2 n. 2 of the Release).

¹²¹ In a recent case a member sued to enjoin the NASD from proceeding against it. After the complaint was filed in court, the NASD proposed to publish a statement in its trade journal concerning the case. Thereupon the member included, in its injunction proceeding, a request that publication of such statement be enjoined. The court denied the injunction on the ground that the facts of the case had already become public through the member's own complaint filed in court and that there was nothing injurious in the proposed statement. The court did say: "... it is well recognized administrative law that injurious publicity ought not to be resorted to in lieu of authorized and lawful sanctions, and I have no doubt that, in an appropriate action where it was shown that injurious publicity was being improperly resorted to, this Court would have ample power to grant injunctive relief." *Otis & Co. v. NASD*, 84 F. Supp. 395, 399 (D. D. C. 1949).

¹²² Sec. 15A(b)(7).

¹²³ *Sherman-Gleason*, 15 S. E. C. 639, 651-654 (1944).

and the clearly gross. In this zone it might be useful to have a schedule of permissible profit or mark-up. But whether or not the Act would permit such a schedule, the difficulty of getting NASD members to agree upon a general rule is apparent.

At one time the Board of Governors, in an effort to be helpful to its members and the District Committees, did issue an elaborate "interpretation" which, among other things, invited attention to the fact that in the vast majority of cases members did not charge mark-ups exceeding 5 per cent.¹²⁴ Thereupon, the Board's Chairman and the Executive Director of the NASD sent a letter to the various District Committees stating that when there is a mark-up in excess of 5 per cent "a duty is imposed upon the member to show to the satisfaction of the Business Conduct Committee that no violation has occurred."¹²⁵ Upon a petition to the SEC, in which it was contended that the Board was attempting to adopt a 5 per cent rule through the guise of an "interpretation," without going through the prescribed rulemaking process, the SEC held that the Board had done no more than issue a permissible interpretation, that a mark-up still had to be shown to be excessive in the light of all the circumstances in order to constitute a violation of the NASD rules, and that the letter from the Board Chairman and the Executive Director was incorrect in attempting to instruct that a mark-up exceeding 5 per cent would be *prima facie* wrongful.¹²⁶

The question came to a further test in *Herrick, Waddell & Co.*¹²⁷ A District Committee had found the respondent guilty of excessive mark-ups on the basis, it seems, of a showing that they exceeded 5 per cent—none being higher than 11.4 per cent—and that other firms in the area had very few mark-ups exceeding 5 per cent. In the view of the SEC the District Committee had ignored various extenuating circumstances advanced by the respondent (the Committee had been affirmed by a divided vote of the Board of Governors). The SEC reversed. In doing so it made the interesting statement that¹²⁸

... we recognize that the industry may properly protect itself against the so-called "high cost" or "submarginal" producer, whose excessive cost of doing business results from inefficiency or unduly high overhead and compels his charging unreasonably high prices to show a profit.

It was also recognized that a mark-up could be unethical even though not fraudulent.¹²⁹ But it was denied that mark-ups exceeding "those customarily charged" are conclusively to be deemed unethical.¹³⁰ A broader view of all the circumstances in each case must be taken.¹³¹

It is not profitable here to explore all the subtleties of the SEC's opinion. But it leaves some question as to how far the SEC would permit the NASD to go in leg-

¹²⁴ See p. 532, *supra*. The letter did *not* imply that a mark-up not exceeding 5 per cent is necessarily appropriate.

¹²⁵ *Re* NASD, 17 S. E. C. 459, 467 (1944).

¹²⁷ Release No. 3935, Mar. 25, 1947.

¹²⁹ *Id.* at 9.

¹³⁰ *Id.* at 7.

¹²⁶ *Id.* at 468 *ff.*

¹²⁸ *Id.* at 10.

¹³¹ *Id.* at 9-11.

isolating more specifically than it has on this subject. Certain passages in the opinion seem to be dealing with what is "unethical" in the absolute sense, without regard to the particular language of the NASD rules, and might be interpreted as meaning that no NASD rule could be sustained which branded a mark-up as wrong unless it were to be measured in each case in the light of "all the circumstances." Such a view might protect NASD members from the necessary arbitrariness of a general rule; but the price of such protection is the arbitrariness inherent in any decision which is to be made "in the light of all the circumstances of the particular case." This inherent arbitrariness becomes very important to the individual charged with a wrong, for the SEC is clear that mere subjective good faith, however strongly evidenced, cannot excuse a violation of an ethical standard.¹³² If a standard can be no more specific than "all the circumstances," there is no way of anticipating what the standard may be. This is a familiar problem of public law; but when laymen are attempting to administer their own affairs they may find it difficult to understand or accept.

Perhaps even more important to the economics of the business than the regulation of mark-ups is the question of assuring compliance with contracts. The view that a contract gives one a right to performance *or* to damages is not shared in the securities business. To a degree true in no other field, those in the securities business condemn a welsher; performance is expected. No ecclesiastical tribunal ever imported into contractual obligations such ethical content as is accepted as of course by most securities dealers.¹³³

Breach of the price maintenance provisions of an underwriting syndicate agreement came into question before the NASD on a charge that such a breach is a violation of an NASD rule which proscribes "conduct inconsistent with just and equitable principles of trade."¹³⁴ On its own motion, the SEC reviewed the NASD Board of Governors' decision that such a charge would be sustained. Strong argument was made to the SEC that such price maintenance agreements are unlawful under the antitrust laws, so that a breach of them could not be deemed unethical. It was also urged that the Maloney Act forbids rules imposing a schedule of prices and requires that rules be designed "to remove impediments to and perfect the mechanism of a free and open market."¹³⁵

Three of the four Commissioners held that price maintenance in an underwriting syndicate agreement does not violate the antitrust laws *per se*; there would be such a violation only if there were special circumstances such as price maintenance for an unreasonable length of time. The fourth Commissioner found it unnecessary to express opinion on the antitrust question.

Three of the four Commissioners held that even though the antitrust laws were

¹³² Cf. Stewart, Release No. 3720, Aug. 7, 1945.

¹³³ Commissioner Healy characterized breach of contract, in the PSI Case, Release No. 3700, June 11, 1945, as "somewhat 'low down'" (see p. 67 of the Release).

¹³⁴ Cf. *People ex rel. Johnson v. New York Produce Exchange*, *supra* note 11.

¹³⁵ Sec. 15A(b)(7). The case was PSI Case, Release No. 3700, June 11, 1945.

not violated by price maintenance in a syndicate agreement, the NASD rule could not be interpreted to warrant punishment for a breach of a price maintenance undertaking because such an undertaking was, literally, a restraint upon a free market. The Maloney Act calls for rules to promote a free market. Hence a rule enforcing a restraint—however reasonable the restraint as far as the antitrust laws were concerned—could not be allowed. Commissioner Healy, dissenting, found no such bar in the Maloney Act. And the majority agreed with Commissioner Healy that, apart from the specific prohibition of the Maloney Act, unwarranted breach of a valid contract amounts to conduct inconsistent with just and equitable principles of trade, so violating the NASD rule. As Commissioner Healy expressed it:¹³⁶

The deliberate, willful and unjustifiable breach of a valid contract between members of the same association, who have relied on each other in a common undertaking, involving risks to their capital is, to my mind, neither honorable, just, nor equitable.

Thus the full Commission recognized that, save for a restricted class of cases involving restraints upon a free market, contracts between members of the NASD, and presumably contracts between such members and their customers in the course of the securities business, could be backed up with the sanctions of the NASD. The efficacy of such sanctions is obviously greater than the mere right of civil suit for damages or even specific performance. The SEC has thus recognized a most important police power on the part of the NASD going far beyond normal conceptions of ethics in business at large and vitally affecting the economics of the trade. Occasion has never arisen for a square SEC ruling; the statements in the case referred to were obiter. But there is little doubt that the threat of NASD disciplinary action is a powerful factor in preserving the integrity of contractual relationships in this business.

This review of the SEC rulings with respect to the NASD can touch only a few of the features of the day-to-day operation of the NASD as an instrument of social control. The cases are few where the SEC has been called on to exercise its review power, and they are still fewer where questions of particular importance have been presented. It will be years, at the present rate, before a rounded body of SEC law for NASD guidance is built up. And not yet has a single case of significance found its way into the courts.¹³⁷

In the meantime the NASD remains a unique institution. If pressure for ex-

¹³⁶ See page 67 of the Release.

¹³⁷ With the exception of a pending appeal to the Court of Appeals for the Second Circuit by R. H. Johnson & Co. from the decision of the SEC reported in Release No. 4694, April 2, 1952, the NASD has been brought into court only once. Otis & Co. sought to enjoin the Board of Governors from proceeding in a disciplinary case on the plea that the question involved in the matter had already been adjudicated in certain previous proceedings involving that company and the SEC. The injunction was denied. The ruling in this case, however, is of no general interest except for its recognition that the doctrine of primary administrative jurisdiction applies to a request that a court interfere with NASD proceedings before they have been concluded. *Otis & Co. v. NASD*, 84 F. Supp. 395 (D. D. C. 1949). See note 121 *supra*.

panding social controls over private business continues to mount, a desire to avoid additional burdens upon the bureaucracy of government may lead to creation of somewhat similar institutions in other fields. If so, the experience of the NASD, its methods, and its relationships to the government reviewing agency will provide a rich source of instruction. Commissioner Healy, who played an active part in the development of the Maloney Act, and who had a keen appreciation of the purposes of the NASD, once observed of it,¹³⁸

It is one of the most interesting and important efforts in the field of government. . . . and may lead those interested in cooperation between business and government to consider its possibilities in other industries.

¹³⁸ PSI Case, Release No. 3700, June 11, 1945 (see pp. 61-62 n. 8 of the Release).