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THE NATIONAL ASSOCIATION OF SECURITIES
DEALERS:

CONTINUING GOVERNMENT-INDUSTRY COOPERATIVE
REGULATION IN THE OVER-THE-COUNTER
SECURITIES INDUSTRY*

THOMAS B. RUTTER†

ALTHOUGH THE INDUSTRY organizations formed under the National Industrial Recovery Act were brought to their demise by a Supreme Court decision¹ and public disinterest over their success,² their lineal descendants continue to have a strong influence on business practices in their respective industries. Chief among these descendants is "the regulating instrument of the securities business,"³ the National Association of Securities Dealers, Inc.,⁴ which regulates the activities of the overwhelming majority of firms⁵ acting as brokers⁶ or dealers⁷ in the over-the-counter securities market⁸ and their sales-

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1. *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

2. Stern, *The Commerce Clause and the National Economy, 1933-1946*, 59 HARV. L. REV. 645, 663 (1946); SCHLESINGER, *THE COMING OF THE NEW DEAL* 400 (1958); *but see* SCHLESINGER, *THE POLITICS OF UPHEAVAL* 283-7 (1960).

3. Report of the National Association of Securities Dealers, Inc. to the Special House Subcommittee on Legislative Oversight of the Committee on Interstate and Foreign Commerce 1 (Subcommittee Print, 85th Cong. 2d Sess.) [hereinafter cited as NASD Report].

4. A non-profit corporation incorporated under the laws of Delaware hereinafter referred to as the NASD.

5. As of 1960 the figure was 4,466 branch offices. *Wall Street Journal*, March 23, 1961, p. 13, col. 1.

6. The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. § 3(a)(4) Exchange Act.

7. The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any other person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity not as a part of a regular business. § 3(a)(5) Exchange Act.

8. "Over-the-counter securities market" means merely that the shares are not traded on any securities exchange. To provide a jurisdictional basis for action by the Securities and Exchange Commission (§ 15(a) of the Securities Exchange Act of 1934) or the NASD (§ 15A(b)(3) of the Securities Exchange Act of 1934), how-

men.⁹ This Association, established pursuant to Section 15A of the Securities Exchange Act of 1934 (hereinafter, Exchange Act),¹⁰ is, by virtue of the Congressional delegation of regulative power to a trade association, "[a]n especially provocative exercise of governmental power by a private organization. . . ."¹¹ It is the purpose of this paper to explore the exercise of that power.¹²

THE ASSOCIATION: BACKGROUND AND DESCRIPTION.

Within a short time of the passage of the National Industrial Recovery Act an Investment Bankers Conference Committee was established, including those engaged solely in the trading of securities as well as investment bankers, and an Investment Bankers Code promulgated. The purpose of this Committee and Code was to bring about self-regulation in the securities industry whereby those practices harmful to the investing public, and in part causative of the stock market crash, might be eliminated. And, after the decision of the United

ever, the transaction must take place via "use of the mails or of any means or instrumentality of interstate commerce."

The following description appears in Bloomenthal, *The Case of the Subtle Motive and the Delicate Art — Control and Domination in Over-the-Counter Securities Markets*, 1960 DUKE L.J. 196, 199:

The over-the-counter market has no shape or form. It is a desultory, organized, ill-defined market completely dependent on the whims, views and decisions of thousands of dealers with no common denominator other than the profit motive. There is no central reporting agency and no way to determine the extent of a day's transactions in a particular security except in retrospect, and then inadequately.

9. The term used in the industry for persons so employed is "registered representative"; the term formerly used, "customer's man," has apparently lost favor due to the fact that they must now be registered with the NASD. "Registered representative" will be used hereafter in this paper. The Association's annual report for 1960 reveals that there are 93,828 registered representatives. Wall Street Journal, *loc. cit. supra*, note 5.

10. 48 Stat. 881 (1934), 15 U.S.C. §§ 78a-78jj (1958). Citations to the Exchange Act will be to the statute as printed separately rather than as found in the U.S.C. (*e.g.*, § 1 and not § 78a).

11. 1 DAVIS, ADMINISTRATIVE LAW TREATISE 141 (2d ed., 1958).

The role of the NASD is an unusual one in the American legal system — a group of private business competitors endowed by the legislature with power to regulate the trade practices of the industry. The only analogous organization which comes readily to mind is also a part of the securities industry — the stock exchanges. (See *infra*, p. 617). Elsewhere there is either no regulation of trade practices, except insofar as certain ones are actionable in the courts by the injured competitor individually, or the regulatory power is in the hands of a governmental body under the direct control of the executive or legislative branch of government. There is, of course, industry participation in varying degrees in the regulation by governmental bodies just as there is industry lobbying in Congress, but the difference between such participation and the adjudicatory power exercised by the NASD is plainly one of kind and not merely one of degree.

12. The range of exploration here is limited to reported decisions of the Securities and Exchange Commission in reviewing NASD orders and court review of the Commission orders. The reasons for this limitation are both pragmatic and theoretic; pragmatic in that opinions of the NASD bodies are not open to the public (see *infra*, note 60); theoretic in that just as a good test of a trial court's functioning is in its record of reversal on appeal, so too a good test of the NASD's functioning is its record on review by the SEC.

States Supreme Court in *Schechter Poultry Corp. v. United States*¹³ holding the NRA unconstitutional made this particular means of self-regulation "impossible,"¹⁴ the benefits of such control became so clear¹⁵ that the Investment Bankers Conference incorporated itself and continued in existence in order to play a major role in shaping the legislation which enabled the return of self-regulation.

The tenor of the legislation which became Section 15A of the Securities Exchange Act of 1938¹⁶ is best seen in the following statement from the Senate Report:

[It is] based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation.¹⁷

Senator Maloney, sponsor of the Act, declared:

In the vast and highly ramified business in securities transacted otherwise than on exchanges, this act is designed to effectuate a system of regulation . . . in which the members of the industry will themselves exercise as large a measure of authority as their natural genius will permit.¹⁸

In addition, it appears that a major reason for the decision to vest regulatory power in a private trade group was an unwillingness to proliferate the duties of the SEC with the concomitant mushrooming size of, and number of personnel in, the Commission. With regard to this reasoning perhaps one can only say that the view of the administrative process taken by Congress varies not simply from Session to Session, but also from agency to agency.

Subsequent to passage of the Maloney Act^{18a} and its incorporation as Section 15A of the Securities Exchange Act, year-long cooperation between the SEC and the Conference produced by-laws which were submitted to the members of the Conference for approval. The re-

13. *Supra*, note 1.

14. NASD Report 2.

15. Ninety per cent of the broker-dealers who replied to a questionnaire sent out by the Conference approved of continuance of the Conference and agreed to support it financially. In addition, the SEC requested the Bankers Conference to participate in the drafting of legislation.

16. Ch. 677, 52 Stat. 1070 (1938).

17. S. Rep. No. 1455, pp. 3-4, 75th Cong., 3d Sess. (1938).

18. Quoted at NASD Report 2. The securities business conducted on the stock exchanges had already been placed under the control of industry organizations in 1934 by § 6 of the Exchange Act. See also, Comment, 48 *YALE L.J.* 633 (1939); Maloney, *Cooperative Regulation*, 9 *INV. BANKING* 18 (1939).

18a. *Supra*, note 16.

sponse was favorable¹⁹ and the association submitted its application for registration as a national securities association, as required by the new law,²⁰ on July 20, 1939.²¹

In allowing the Conference to register under its new name, National Association of Securities Dealers, Inc., the SEC generally approved of the provisions enacted by the Association²² but found only "minimum compliance" with section 15A in two provisions: the efficacy of volunteer self-regulation²³ and the equitable allocation of dues among members.²⁴ The SEC also noted that the Rules of Fair Practice adopted by the NASD were well adapted to "eliminating abuses which might well lead to the defrauding of investors" and "to promote just and equitable principles of trade."²⁵ It was also held that the Rules of Fair Practice providing that members of the Association could deal with non-member broker dealers only on the same terms as members of the investing public,²⁶ and that "the giving of concessions, discounts, or other allowances under certain circumstances,²⁷ do not appear to violate any of the prohibitions listed" in section 15A(b)(7).²⁸ Finally, the SEC also questioned the lack of rules providing for inspection of members' books or assuring the solvency of a member.²⁹ Nevertheless, the application for registration was granted — the only such application ever made.

The NASD, as presently constituted, consists of thirteen districts allocated generally according to geographical proximity and co-extensive with the Federal Reserve Districts. Because of the

19. How favorable is another question, in view of the fact that of a membership of between 1500 and 1600, only 757 ballots were received of which 35 disapproved in some way. NASD Report 3.

20. § 15A (a).

21. NASD Report 3.

22. In the Matter of Application by National Association of Securities Dealers, Inc. for Registration as a National Securities Association, 5 S.E.C. 627 (1939).

23. *Id.* at 629.

24. *Id.* at 630.

25. *Id.* at 631.

26. NASD Manual D-13, Rule 25. This power is expressly provided for in § 15A(i) of the Exchange Act.

27. NASD Manual D-12, Rules 23 and 24.

28. The pertinent part of § 15A(b)(7) provides that registration shall not be granted unless it appears that the association rules are designed "in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers. . . ."

The result of these rules has been that in the distribution of a new issue of securities, and apparently in other securities transactions, members can and do give a quarter point or more differential in price to other members which is not given to nonmember purchasers.

29. *Supra* note 22, at 632. Both of these shortcomings are now cured. As to the former, after a voluntary questionnaire system proved ineffective, the NASD now uses itinerant examiners who are to have access to the books of any member and whose visits are not warned of in advance. As to the latter, the NASD now enforces the Federal Reserve Board margin requirements.

jurisdictional limitations under which the Securities and Exchange Commission operates,³⁰ the NASD is similarly limited to those engaged in the securities business via "use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange."³¹ The By-Laws of the Association further limit membership by requiring that the member be one "authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business."³² and, that he has been engaged in the securities business for at least one year unless he passes a written examination demonstrating technical proficiency in the securities business.³³

An additional qualification for membership requires that the member not be under any disability arising out of previous expulsion from the Association, revocation of his registration with the SEC, or conviction of a crime with regard to practice of the securities business.³⁴ If the applicant is denied membership by the local District Committee,³⁵ he has the right of appeal to the Board of Governors³⁰ and, ultimately, to the SEC.³⁷ With regard to these qualifications on eligibility for membership, the SEC has held that, in the absence of any grounds for denial other than those which the SEC had previously found inadequate as a basis for continuing the revocation of the member's registration before the SEC as a broker-dealer, the NASD is required to re-admit him to membership in the Association.³⁸

30. See *supra* note 8.

31. § 15A(b)(1). Transactions effected on a national securities exchange are exempted by definition of over-the-counter market. Furthermore, such transactions are regulated by the exchanges themselves under the guidance of the SEC pursuant to § 6 of the Exchange Act. (See note 18, *supra*.)

32. NASD Manual C-5, By-Laws of NASD, Article I, Section 1.

33. NASD Manual C-6, By-Laws, Article I, Section 2(b). The provision for a written examination to test new entrants into the business is one of the most recent achievements of the NASD.

34. NASD Manual C-5, By-Laws, Article I, Section 2(a).

35. NASD Manual C-10, By-Laws, Article I, Section 4(c).

36. *Id.* Section 4(d).

37. *Id.* Section 4(e). This is based on the general review power of the SEC, § 15A(g), and the membership clause of the Maloney Act, § 15A(b)(3). "Review of denial of membership is usually brought under § 15A(b)(4) but if there is a question whether, in fact, an applicant is subject to a disqualification, any unfavorable NASD action may be reviewable under § 15A(g)." White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250, 253 (1959).

38. Lawrence R. Leiby, 25 S.E.C. 28 (1947). The *Leiby* decision is the leading case in the area of SEC review of denial of membership in the NASD, an area basically outside the scope of this article.

A recent case in this area is also interesting for the light it casts on the SEC approach to denial of membership in the NASD. There — *Matter of John Munroe*, CCH Fed. Sec. L. Rep ¶ 76,766 (Exchange Act Release No. 6513) (1961) — the member had been expelled from the NASD as well as suspended for five years from the New York Stock Exchange for understating his income in his tax returns. Apparently, though, his registration as a broker-dealer with the SEC was not revoked. Then, three years after his expulsion, and while his Stock Exchange suspension was

The local organization in each of the districts is the District Committee,³⁹ consisting of a number of members⁴⁰ who are active participants in the business and are appointed for three-year terms.⁴¹ Elections for membership are held only if there is a contest for the seats on the Committee;⁴² such a contest can occur only if ten per cent of the membership petitions for a vote on a name other than that proposed by the district nominating committee (a group appointed by the incumbent District Committee).⁴³ Votes in these elections are allocated to member firms, rather than to individual representatives, for the obvious reason of protecting the smaller firms from being overborne in the selection of Committee members by the larger firms having more registered representatives. One of the most important criteria in the selection of Committee members is that there be "appropriate and fair representation . . . of the various sections of the District and of all classes and types of firms engaged in the . . . business within such District."⁴⁴ The result is that in a given District there is likely to be representation of the large, multi-office national member; the large, big-city member; the small, big-city member; and, several members from small-town offices in various parts of the District.⁴⁵

The functions of the District Committee are basically two: (1) to educate the membership in the objects of the NASD, and (2) to report on the practical operation of the various rules and regulations promulgated by the Association.⁴⁶ Furthermore, the chairmen of the respective Committees act as an advisory council to the Board of Governors to effectuate "maximum administration at the local level."⁴⁷

still effective, he successfully petitioned the SEC to order his re-admission into the NASD. The grounds on which the SEC relied in ordering his readmission were: (1) a pledge of future good behavior by the member; (2) the absence of any implication of fraud or negligence in the preparation of the income tax returns in question; (3) a three-year suspension from membership in the NASD was sufficient punishment in the light of all the facts.

See also, Cherrington, *National Association of Securities Dealers*, 27 HARV. BUS. REV. 741, 757 (1949); Loss, *SECURITIES REGULATION* 770 (1951).

39. NASD Manual C-29, By-Laws, Article IV, Section 10.

40. The number is apparently proportional to the number of members in the district, but may not exceed 12 under Section 10 of Article IV of the By-Laws.

41. NASD Manual C-29, By-Laws, Article IV, Section 10.

42. NASD Manual C-30, By-Laws, Article IV, Section 12(c).

43. It should be noted here that members of the Committee rarely succeed themselves in office. By-Laws, Article IV, Section 12(a).

44. NASD Manual C-30, By-Laws, Article IV, Section 12(a).

45. District 8, for example, in 1960 included five members from Chicago, two from Milwaukee, and one each from Benton Harbor, Mich., Minneapolis, Indianapolis, Des Moines and Detroit.

46. NASD Manual C-33, By-Laws, Article IV, Section 19.

47. NASD Report 4.

The controlling body of the NASD is a Board of Governors⁴⁸ composed of members from each of the Districts in proportion to the number of members in that District. Thus, five members of the Board are from the New York District; three from the Midwestern District (which includes Illinois); three from the California District, and one from each of the remaining districts for a total of twenty-one members.⁴⁹ The term of office,⁵⁰ means of election,⁵¹ and power to succeed themselves in office⁵² is the same for members of the Board as for members of the District Committees. Finally, there is an executive director and a secretary, the only paid officers of the Association.⁵³

The Board is endowed with the over-all policy-making functions of the Association but it is especially empowered to "adopt for submission to the membership . . . such By-Laws, rules and regulations, make such interpretations, issue such orders and directions, and make such decisions as it deems necessary or appropriate; and it may prescribe maximum penalties for violations" ⁵⁴ Within the scope of these powers, the Board has regularly developed guide lines and techniques for greater control and efficiency in "cooperative regulation of the over-the-counter business in the public interest and for the protection of investors."⁵⁵ In this sense, the Association has in fact operated with regard to the over-the-counter market in a way similar to that in which the national securities exchanges have operated with regard to their members and their members' dealings in listed securities.⁵⁶

Among the more important devices developed by the Board for protection of investors and the public interest are: (1) testing of new entrants into the business; (2) supervision of sales literature intended for investors; (3) publication daily of a National Quotations Bulletin, known as the "pink sheet," which lists the bid and asked price of a great number of the securities handled over-the-counter, thereby

48. NASD Manual C-25, By-Laws, Article IV, Section 2.

49. NASD Manual C-26, By-Laws, Article IV, Section 3.

50. *Id.* Section 4.

51. NASD Manual C-27, By-Laws, Article IV, Section 6.

52. *Ibid.*

53. NASD Manual C-35, By-Laws, Article V, Section 2. Members of the Board of Governors are entitled only to "reasonable out-of-pocket expenses." NASD Manual C-36, By-Laws, Article V, Section 7.

54. NASD Manual C-25, By-Laws, Article IV, Section 2.

55. In the Matter of Application by National Association of Securities Dealers, Inc. for Registration as a National Securities Association, 5 S.E.C. 627, 628 (1939).

56. See, *e.g.*, In the Matter of National Association of Securities Dealers, Inc., 19 S.E.C. 424, 483 (dissent) (1945); *id.* 20 S.E.C. 508, 512 (1945) where it is suggested that this similarity in regulation by the exchanges and the NASD was the purpose of Congress in passing the Maloney Act.

For a comparison of the two forms of regulation see Westwood & Howard, *Self-Government in the Securities Business*, 17 LAW & CONTEMP. PROB. 518 (1952).

providing a single central source of information as to share prices;⁵⁷ (4) development, interpretation and enforcement of a Uniform Practice Code which, in essence, consists of trade usages and customs involving the relationship of buying and selling brokers who are dealing with one another in terse, technical, oral terms rather than under expansive, written contractual terms; (5) examination of member firms' books by professional examiners to determine compliance with NASD and SEC rules,⁵⁸ and (6) promulgation of Rules of Fair Practice.

Clearly, the Rules of Fair Practice, which more narrowly define "just and equitable principles of trade," are the essence of the NASD function, for these are the regulations under which a broker-dealer must conduct his business in order to protect the investing public and for violation of which he is held to account in an Association disciplinary proceeding.⁵⁹ Accordingly, the remainder of this paper will be devoted to an initial analysis of the Rules of Fair Practice and NASD disciplinary proceedings as reflected in SEC decisions which review NASD action.⁶⁰ The plan is first to examine the procedure in disciplinary proceedings, and then the substantive Rules of Fair Practice.

THE NATURE OF NASD DISCIPLINARY PROCEEDINGS.

As a condition of registration as a national securities association the Maloney Act declares that:

[T]he rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable

57. In a disciplinary review proceeding prior to the establishment of this service the SEC said: "We are convinced that the publication of *bona fide* over-the-counter quotations is desirable and necessary. Discussions with the NASD have been under way for some time with a view to publishing quotations which would not have the misleading character of those now published." *Sherman Gleason & Co.*, 15 S.E.C. 639, 653, n. 28 (1944).

58. These books and records must be always available for examination as a condition of membership. Furthermore, these same books and records are subject to the subpoena power of the SEC whose examiners may also scrutinize them.

59. See e.g., Grant, *The National Association of Securities Dealers: Its Origin and Operation*, 1942 WISC. L. REV. 597. *In the Matter of National Association of Securities Dealers*, 20 S.E.C. 508, 510 (1945).

60. See note 12, *supra*. Concentration on, and limitation to, SEC review proceedings, although analogous to a discussion of American law based solely on United State Supreme Court decisions, is necessitated by the fact that proceedings before the NASD bodies are not made public and thus there are no records on which a study can be based. The proceedings come to light only in the event of appeal to the SEC whose proceedings are public. Reports of decisions are, however, made known to members through selected reporting of untitled cases via the Association newspaper, *The NASD News*. And, in one case, a request that the NASD proceedings be made public was honored.

This paper also does not encompass those cases where the NASD petitions the SEC to continue the membership of a broker-dealer or registered representative

profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges;⁶¹

the rules of the association provide that its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or any other fitting penalty, for any violation of its rules;⁶²

the rules of the association provide a fair and orderly procedure with respect to the disciplining of members⁶³

In accordance with these provisions, the By-Laws of the Association authorized the Board of Governors to adopt for submission to the membership "Rules of Fair Practice"⁶⁴ which include, among other things, procedural rules for disciplinary proceedings⁶⁵ and a schedule of penalties.⁶⁶ This By-Law also provides that the Board of Governors shall have the power "To make and issue interpretations of all rules of fair practice adopted."⁶⁷ The Rules of Fair Practice, including twenty-eight rules governing substantive matters of business practice,⁶⁸ were found by the SEC, upon adoption, to be consistent with the above-quoted provisions of section 15A.⁶⁹ Similarly, four types of penalties were approved:⁷⁰ (1) censure; (2) fine not in excess of \$500; (3) suspension from the NASD; (4) expulsion from the NASD, or, in the case of a registered representative, revocation of his registration. A Code of Procedure for Handling Trade Practice Complaints was also promulgated.⁷¹ In addition to providing for jurisdiction and venue, procedural rules covering such matters as filing of complaints and answers, hearings, written decisions, and rights of appeal were set out.

where the individual has previously been expelled by the SEC for misconduct. The general principles of that area are stated in 22 S.E.C. 880 (1946). A few of the leading cases are *Greene & Co.*, 23 S.E.C. 429 (1946), *Edward E. Trost*, 25 S.E.C. 648 (1947), and *Life Insurance Fund Management Co.*, 37 S.E.C. 376 (1956).

61. § 15A(b)(7) Exchange Act.

62. § 15A(b)(8) Exchange Act.

63. § 15A(b)(9) Exchange Act.

64. NASD Manual C-39, By-Laws, Article VII, Section 1.

65. *Id.*, Section 3(b).

66. *Id.*, Section 3(c).

67. *Id.*, Section 3(g).

68. NASD Manual D-5 to D-20, Rules of Fair Practice, Article III.

69. *Loc. cit.*, *supra* note 22.

70. NASD Manual D-23, Rules of Fair Practice, Article V, Section 1.

71. NASD Manual E-1 to E-11.

An alternative form of proceeding, the minor violation procedure, has also been established whereby the charged member admits the violation, waives any hearing, and accepts a penalty not greater than a fine of one hundred dollars. He also furnishes a statement pledging future observance of and compliance with the rules.⁷² The member's observance of this pledge is then kept under close scrutiny by the District Business Conduct Committee,⁷³ and breach of the pledge is itself an unethical trade practice:

It is obvious that proper performance by the NASD of its duty to secure adherence to just and equitable principles of trade for the protection of investors requires that commitments made to it be respected, especially where such commitments were the basis for the withholding of sanctions because of prior violations and their breach results in a further violation. The imposition on Parker of a sanction for the breach of the commitment and the repeated violation was clearly in order⁷⁴

The constitutionality of this delegation of power to the NASD under the Maloney Act was first attacked in a petition to the SEC urging that the Association had acted ultra vires its powers in adopting a rule without first getting the approval of the membership.⁷⁵ The theory of this alternative line of attack was that the Association was per se bad in that Congress could not constitutionally place such broad powers of regulation in the hands of a private trade group. The SEC, following the usual practice of administrative agencies when faced with a challenge on constitutional grounds, declined to pass on the issue, saying:

We do not here consider the petitioner's argument that Section 15A is unconstitutional, having consistently held that such a question may not properly be decided by an administrative tribunal.⁷⁶

No appeal was taken from the decision of the SEC in that case, but the constitutional issue was subsequently raised in the first petition to the courts to review an order of the SEC sustaining NASD ac-

72. NASD Manual E-5, Code of Procedure, Section 12.

73. NASD Manual E-9, Code of Procedure, Section 20.

74. Gilbert Parker, 34 S.E.C. 385, 389 (1952).

75. In the Matter of NASD, Inc., 17 S.E.C. 459 (1944). The rule at issue here was the "5% policy" (see *infra* pp. 645-50).

76. *Id.*, at 461, n. 5. But compare Boren & Co., CCH Fed. Sec. L. Rep. ¶ 76,718 (Exchange Act Release No. 6367) (1960) where the same discretion was not shown by the SEC in deciding that an NASD Rule of Fair Practice was not unconstitutional under the Sixth Amendment for failure to provide an ascertainable standard of guilt. Of course, in *Borcu* rhetoric was available to conceal the substantive issue involved — the purpose of § 15A is not penal but remedial. (See R. H. Johnson & Co., 33 S.E.C. 180, 185 n.6 (1952)).

tion.⁷⁷ There, Judge Frank, writing for a unanimous court, gave short shrift to the constitutional argument, holding:

In the light of the statutory provisions concerning (a) the Commission's power, according to reasonably fixed statutory standards, to approve or disapprove of the association's Rules, and (b) the Commission's review of any disciplinary action, we see no merit in the contention that the Act unconstitutionally delegates power to the Association.⁷⁸

Unfortunately, the cases cited in support of this proposition are at best inapposite.⁷⁹ And, in fact, in two of the three cases cited the Supreme Court expressly declared that the regulatory power in question was not in the hands of a private trade group.⁸⁰ Yet, it seems safe to say that if the constitutionality of the delegation of power under the Maloney Act were raised today before the United States Supreme Court, it would be upheld. Despite the continued presence of conflicting, and apparently irreconcilable, lines of authority on the question of the delegability of regulatory power to private groups,⁸¹ it should be recalled that in but two instances has the Court struck down the delegation of power to an administrative agency.⁸² Both those instances involved the National Industrial Recovery Act and were subject to vagaries in historical setting and litigation unlikely to be repeated.⁸³ Accordingly, if one may use as a measuring rod the standards applied in the delegation of power to *ordinary* administrative agencies — a

77. *Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir., 1952) *cert. denied* 344 U.S. 855 (1952) *affirming* 33 S.E.C. 180 (1952).

78. *Id.* at 695.

79. *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940); *Opp Cotton Mills v. Administrator of Wage and Hour Division*, 312 U.S. 126 (1941); *Rice v. Chicago Board of Trade*, 331 U.S. 247 (1947).

80. *Rice v. Chicago Board of Trade*, *supra* note 79, at 253, n.4 ("We therefore have no attempt here to endow private groups with law-making functions."); *Sunshine Anthracite Coal Co. v. Adkins*, *supra* note 79, at 399, ("Since law-making is not entrusted to the industry, this statutory scheme is unquestionably valid.")

81. Holding the delegation constitutional: *Butt City Water Co. v. Baker*, 196 U.S. 119 (1905) (Federal statute empowering miners to promulgate regulations as to how mining claims should be established); *St. Louis Ry. Co. v. Taylor*, 210 U.S. 281 (1908) (American Railway Association empowered by Congress to regulate height of drawbars on freight cars); *Cusack Co. v. Chicago*, 242 U.S. 526 (1917) (Municipal ordinance barring billboards unless consented to by neighbors).

Holding the delegation unconstitutional: *Eubank v. City of Richmond*, 226 U.S. 137 (1912) (Municipal zoning ordinance allowing two-thirds of the property owners to establish set-back lines); *Seattle Title Trust Co. v. Roberge*, 278 U.S. 116, (1917) (Municipal zoning ordinance prohibiting establishment of old folks home without neighbors' consent); *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936) (Power to set hours and wages delegated to producers and miners held bad because "The power conferred upon the majority is, in effect, the power to regulate the affairs of an unwilling minority. . . .")

82. *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935); *Schechter Poultry Corp. v. United States*, *supra*, note 1.

83. Stern, *loc. cit.*, *supra*, note 2; Jaffe, *An Essay on Delegation of Legislative Power*, 47 COLUM. L. REV. 359, 561, 569 *et seq.* (1947).

tenable premise from which to begin by virtue of the very review power in the SEC relied on by Judge Frank⁸⁴ — it seems plain that the purpose of protecting the public and investors,⁸⁵ and the standards for achieving that purpose,⁸⁶ are sufficiently clear on the face of the statute to sustain the existence of the NASD under the United States Constitution, subject to the watchful eye of the SEC.

District Business Conduct Committee.

A complaint may be filed by an aggrieved person against any member of the Association with the District Business Conduct Committee.⁸⁷ But, in fact, the overwhelming majority of charges are brought by the District Committees of their own motion⁸⁸ as a result of examination of member books and records. Indeed, of the cases reviewed by the SEC, in only one, *Philips & Co. and Gerald G. Bernheimer*,⁸⁹ was the complaint originally filed by a private party, that is, a customer. Original jurisdiction for all complaints is in the District Business Conduct Committee; venue is laid in the District where the member firm has its principal office, or, at the office where the violation occurred.⁹⁰ The complaint filed must be in writing and "specify in reasonable detail the nature of the charges."⁹¹ This last requirement has been interpreted by the SEC to mean that ". . . the complaint . . . which sets forth the names of the customers, the transactions of purchase and sale, and the amount of mark-ups charged, was not deficient."⁹²

Both for the purpose of determining whether a complaint should be filed⁹³ and for the investigation of complaints,⁹⁴ the Business Conduct

84. The SEC's power of review was similarly held to be a *sine qua non* of approval of the NASD's amendment of its By-Laws in order to expand its jurisdiction to cover individuals as well as firms. In the Matter of NASD, *supra*, note 59, at 516 (1945).

85. See pp. 618-19 *supra*.

86. Certainly "just and equitable principles of trade" is no more vague than "just and reasonable rates" or "unfair methods of competition" which have already been accepted by the Court. Professor Jaffe, in his article cited *supra*, note 83, suggests that the constitutional infirmity associated with the notion of delegation of legislative powers is "in the field of federal administration . . . essentially a caveat, a hint of a reserved power. (47 COLUM. L. REV. at 592). See also, Jaffe, *Law Making By Private Groups*, 51 HARV. L. REV. 201 (1937).

87. NASD Manual D-21, Rules of Fair Practice, Article IV, Section 2.

88. *Id.*, Section 3.

89. 37 S.E.C. 66 (1956).

90. NASD Manual E-1, Code of Procedure Sections 2 and 3.

91. NASD Manual E-2, Code of Procedure, Section 4.

92. *R. V. Klein Co.*, 36 S.E.C. 146, 149 (1954); *rev'd on other grounds Klein v. SEC*, 224 F.2d 861 (2d Cir. 1955); SEC order modified in *R. V. Klein Co.*, 36 S.E.C. 419 (1955). The complaint here was based on excessive mark-ups in the sale of oil royalties and the amount of mark-ups charged was a necessary part of the complaint.

93. NASD Manual D-21, Rules of Fair Practice, Article IV, Section 5.

94. *Id.*, Section 4.

Committee has the power to require the member to submit a report on the activities in question and open its books, records and accounts for investigation. "[A] business conduct committee acting pursuant to Article IV, Section 5, of the Rules of Fair Practice, does have the power to compel the NASD members in its jurisdiction to make periodic reports with respect to their trade practices"⁹⁵ both to ascertain what in fact the trade practices are, and also to determine, by comparison of the information supplied, whether some member or members should be made the subject of unfair trade practice charges. Similarly, the refusal of the member to supply such information during the course of an investigation of a complaint is itself a violation of the Rules of Fair Practice.⁹⁶ Furthermore, the SEC sustained these investigatory powers where the District Committee was charged, in one instance,⁹⁷ with prejudice against the member and, in another instance,⁹⁸ with misuse of the information. As a ground for sustaining the NASD powers in these cases, the SEC has ruled that a member's "remedy against any misuse of the data by the committee lay in an appeal from their actions,"⁹⁹ not in a refusal to supply the data.¹⁰⁰

But the NASD appears to have heeded the dictum of the court in *Otis & Co. v. NASD*.¹⁰¹ There, a member firm had refused to supply certain information to a District Committee on the ground that it fell within the protection of the attorney-client privilege¹⁰² and, after the District Business Conduct Committee had imposed a two-year suspension for this refusal, the member sued to enjoin the Association from demanding the information and from enforcing the suspension. The District Court, although dismissing the complaint for failure to

95. Sherman Gleason & Co., *supra* note 57, at 654. The NASD finding of violation here was not affirmed by the SEC, however, since this was the first such questionnaire sent out by a NASD body. Parenthetically, the questionnaire was a survey of mark-up practices which led to establishment of the "5% policy" (see *infra* pp. 645-50) and the complaint against Sherman Gleason & Co. was based on their pricing practice. It is also worth noting that this case was the first in which the SEC was called upon to review NASD action.

96. Boren & Co., *supra*, note 76.

97. Sherman Gleason & Co., *supra*, note 57.

98. Boren & Co., *supra*, note 76. The information had been transmitted to persons not involved in the investigation with the result that a representative under investigation had lost his job at a bank.

99. Sherman Gleason & Co., *supra*, note 57, at 654.

100. The power of appeal to the SEC may be nonexistent, though, since the Commission has jurisdiction only if affirmative disciplinary action is taken by the NASD. See *In the Matter of NASD*, *supra*, note 59. And, of course, this does not cure a situation like that in Boren & Co., *supra*, note 76, where the employer is not subject to SEC regulation.

101. 84 F. Supp. 395 (D.D.C. 1949).

102. The firm also successfully withstood SEC inquiry into the correspondence in question. *Otis & Co. v. SEC*, 176 F.2d 34 (D.C. Cir. 1949). *Rev'd per curiam*, 338 U.S. 843.

exhaust available administrative remedies (an appeal to the Board of Governors was pending), declared:

[I]f the action of the District Committee is effective, the [attorney-client] privilege of the communications here involved would be destroyed. One would suppose that the Association would be reluctant to give widespread [the] impression . . . that it was exercising its disciplinary power so harshly until there has been judicial determination that it has the right to do so.¹⁰³

Accordingly, although the "remedy . . . lay in an appeal" to the SEC, there are also the usual powers possessed by a court of equity to prevent the NASD from over-extending its investigatory powers.

Possession of such broad investigatory powers coupled with the power, *sua sponte*, to bring charges, led to difficulties for the Association in one instance where a dealer in oil royalty securities was charged with taking mark-ups in excess of fifty per cent:

[T]he failure of the [District Business Conduct] Committee to discipline him in 1950 justified Klein in believing that a 50% mark-up did not violate the rules. We do not regard those facts as constituting an estoppel. We do hold that they constituted an interpretation of the Rules [of Fair Practice] on which Klein reasonably relied. . . . There were no circumstances with respect to his conduct in 1950 . . . that distinguished it from that for which he was expelled. (*Klein v. SEC*, 224 F.2d 861, 864 (2d Cir. 1955)).

But, neither the SEC nor the courts have since applied the *Klein* rule to other facts. In the two cases raising the *Klein* issue before the SEC, a distinction was drawn between oil royalties (involved in *Klein*) and the type of security involved in each of those cases. This distinction was based on the ground that, whereas no clear pricing policy had been established by the NASD as to oil royalty securities prior to *Klein*,¹⁰⁴ there was a clear policy as to the pricing of other securities. Accordingly, taking a fifty per cent mark-up on oil royalties, in keeping with customary practice, was different from taking large mark-ups in other securities. Also, in one of the two aforementioned cases, *Mitchell Securities, Inc.*,¹⁰⁵ the SEC noted that for most of the transactions in question there was no reasonable basis on which reliance, in the *Klein* sense, could be based. This was so because the transactions had occurred before the NASD could have acted, and the

103. *Otis & Co. v. NASD*, *supra*, note 101, at 399.

104. The NASD has, since the *Klein* case, issued an interpretation with respect to the applicability of NASD mark-up policy to transactions in oil royalty securities. NASD Manual G-17.

105. 37 S.E.C. 178 (1956).

NASD had moved relatively quickly upon discovering the pricing policy of the member. In the second case before the SEC raising the *Klein* issue, *Midland Securities, Inc.*,¹⁰⁶ the defence of reliance was rejected on the ground that the mark-ups there were so excessive as to preclude the reasonableness of any reliance on the failure of the NASD to act.

Finally, the *coup de grace* was dealt *Klein* by the Second Circuit in *Boruski v. SEC*, 289 F.2d 738 (2d Cir. 1961), where a dealer, whose suspension by the NASD had been affirmed by the SEC, urged on appeal that the *Klein* rule was applicable. The dealer argued that the prior failure of the NASD to object to his bookkeeping methods precluded basing a violation of the Rules of Fair Practice on those methods now. In rejecting this argument the court held:

That case [*Klein*] was decided on the specific facts there presented — namely, implied approval of a 50% mark-up. Its holding cannot be extended to implied approval of an inadequate book-keeping system because of failure to object.¹⁰⁷

Although this decision in *Boruski* renders extinct the *Klein* rule, there is yet something to be said for the underlying notion of the rule which makes it not unlike the more common theories of estoppel. Perhaps a restatement of Judge Frank's *Klein* rule in the following terms would meet with a better reception by the SEC and the courts: If the acts of the member are such that it could not reasonably believe they constituted fair dealing, then the failure of the NASD to bring disciplinary proceedings should not be a ground for defence. If, however, the practices fall within an area where there is divergence of opinion as to their propriety, then failure to initiate proceedings promptly, after investigation, should be a good defence in the disciplinary proceedings.

A member who is the subject of a complaint has the right to file an answer¹⁰⁸ and have a hearing before the District Business Conduct Committee¹⁰⁹ at which he may be represented by counsel.¹¹⁰ The SEC, taking into consideration the peculiar nature of private trade

106. CCH Fed. Sec. L. Rep. ¶ 76,727 (Exchange Act Release No. 6413) (1960).

107. *Boruski v. SEC*, 289 F.2d 738, 740 n.2 (2d Cir. 1961). One will note, of course, that *Klein* itself was a Second Circuit decision.

108. NASD Manual E-3, Code of Procedure, Section 7.

109. *Id.* Section 8.

110. NASD Manual C-42, By-Laws, Article VII, Section 4. Members are frequently reluctant to employ counsel for the purposes of such hearings (as is often the case in commercial arbitration cases, and other trade quasi-judicial proceedings) because of the possible adverse impression created and because of the overly legalistic aura usually surrounding the appearance of counsel. See Sherman Gleason & Co., *supra* note 57, at 648.

association regulation, has laid down the following standard for conduct of committee proceedings:

A District Committee, composed of active competitors of an accused firm and engaged in the delicate task of policing their own industry . . . must apply its experience and knowledge to the evidence before it. . . . if the member [accused] offers evidence of relevant circumstances, the NASD must give such evidence proper consideration in determining whether there has been a violation of its rules. And where, as in this case, it does not appear that the mark-ups are in themselves clearly and substantially in excess of those customary in the vicinity, the NASD has the affirmative duty of exploring the questioned transactions and all pertinent circumstances before reaching any conclusion on the reasonableness of the mark-ups.¹¹¹

Association disciplinary bodies may, however, also consider the member's prior record of compliance with the Rules of Fair Practice in deciding the punishment to be imposed.

The distribution of the evidentiary burden¹¹² is such that the District Committee, or other complainant, must first make out a prima facie case of violation of the Rules of Fair Practice, whereupon the burden of going forward with a defence shifts to the charged member.¹¹³ In addition, the decision of the District Committee, to exonerate the member or hold him guilty of a violation, must be in writing. If the decision is that there was a violation, then the opinion must contain a statement (1) of the acts or omissions to act of the member, (2) of the specific rules violated, (3) that the acts constitute "conduct inconsistent with just and equitable principles of trade"¹¹⁴ and (4) of the penalty imposed.¹¹⁵

The accused member is also required to bear such part of the costs as is "fair and appropriate in the circumstances,"¹¹⁶ but assessment by NASD disciplinary bodies of the accused member's share of costs has led to problems in several cases reviewed by the SEC. In fact, reduction of costs is a recurring phenomenon in the cases. In *Managed Investment Programs*, the Commission held:

111. Herrick, Waddell & Co., 25 S.E.C. 437, 447 (1947). See also note 112, *infra*.

112. Compare, In the Matter of NASD, *supra*, note 75, at 468, where it is said: "To speak of formal burdens of proof in the context of a disciplinary proceeding held before a committee of the NASD may appear somewhat over-technical, since 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."

113. *Ibid.*; Herrick, Waddell & Co., *supra*, note 111.

114. See Rule 1 of the Rules of Fair Practice, *infra*, p. 636.

115. NASD Manual E-4 and E-5, Code of Procedure, Section 11.

116. NASD Manual D-24, Rules of Fair Practice, Article V, Section 3.

We believe that the scope of our review under the Act to determine whether a penalty imposed is excessive or oppressive includes the determination whether an amount assessed as costs of the proceedings is proper. Unless the costs are itemized we are unable to determine whether the costs were properly imposed.¹¹⁷

For failure to itemize, the costs were set aside and the NASD was then permitted to re-assess them.

More recently, the SEC has limited the amount of costs assessable again the accused member to \$1,000. In the leading case of *Boren & Co.*,¹¹⁸ the District Committee had assessed costs in excess of \$7,500 which included counsel fees for the committee and the salaries of employees engaged in handling the administrative and secretarial aspects of the proceeding. In addition, the member's share of the costs assessed on appeal to the Board of Governors was better than \$750 so that the total costs imposed on him amounted to over \$8,300. In refusing to affirm this portion of the Association's order, the SEC emphasized that the limit on fines was \$500¹¹⁹ and that the former maximum on assessable costs, just recently dropped, had been \$500. It went on to rule that \$1,000 "is the maximum that can reasonably be assessed in the absence, as here, of a clear showing of deliberate obstruction and delay by [the accused member]."¹²⁰ In *Gordon M. Copp*¹²¹ the Commission stated the principle as follows :

[P]art of the costs incurred in disciplinary proceedings is to be borne by the NASD, and . . . items of expenses which are not directly attributable to the proceedings are not to be assessed against a respondent.

But, the Commission did go on to note that in proceedings subsequent to these decisions,

. . . the NASD has in conformity with those principles eliminated from the assessment of costs the salaries of employees as well as telephone and postage expenses.

It seems clear that the SEC has adopted the proper approach in this ruling in view of three considerations. First, disciplinary proceedings are not solely, or even primarily, intended as punitive devices; rather, the main purpose is to educate the membership in the better ways of conducting its business. Second, the dues and assessments

117. 37 S.E.C. 783, 791 (1957).

118. *Supra*, note 76.

119. NASD Manual D-23, Rules of Fair Practice, Art. V, Sec. 1.

120. *Boren & Co.*, *supra*, note 76; see also Maryland Securities Co., Inc. (Exchange Act Release No. 6442) (1960).

121. CCH Fed. Sec. L. Rep. ¶ 76,805 (Exchange Act Release No. 6644) (1961).

paid by each member of the Association are intended to partially defray the expenses of such proceedings. Finally, inasmuch as the \$500 limit on fines does exist, to permit the Committees to exercise their ingenuity in imposing costs would make the limit on fines ineffective and meaningless.

The Board of Governors.

The Board of Governors has appellate jurisdiction over decisions of District Business Conduct Committees whether the District decision is one imposing a penalty or one dismissing the complaint.¹²² Such review may be had by the Board on its own motion¹²³ within thirty days of the District decision or upon appeal within fifteen days by any party aggrieved by the penalty or dismissal below.¹²⁴

The exclusiveness of this means of redress from District Committee action — appeal to the Board of Governors, review by the SEC and then to the Circuit Court of Appeal — has been upheld by both the federal and state courts on the theory of federal preemption as well as exhaustion of administrative remedies. In *Otis & Co. v. NASD*,¹²⁵ where a charged member sought an injunction against enforcement of the District Committee's order suspending him from membership, the District Court held that in the absence of "an appropriate subject with which this Court . . . may deal, the Court does not have the power to grant the relief sought, and the complaint must be dismissed."¹²⁶ The basis for the holding was stated thus:

[T]he plaintiffs have not yet exhausted their remedy even before the final authority of the Association. . . . Furthermore, it is equally apparent that no final action adverse to the plaintiffs can be effective until they have had an opportunity to apply to a Court of Appeals for a stay of such action.¹²⁷

122. NASD Manual E-6, Code of Procedure, Section 14.

123. The Board frequently exercises this power to "call up" cases when it is felt that guidance in a particular area of practice is needed. See, for example, the Public Service of Indiana cases (Matter of NASD, 19 S.E.C. 424 (1945)) discussed *infra* pp. 636-37 where the Board called up all seventy of the cases in which fines were imposed by the various District Committees as well as a few of the thirty cases in which the complaint was dismissed.

124. NASD Manual E-6, Code of Procedure, Section 14.

125. *Supra*, note 101.

126. 84 F. Supp. 395, 398 (D.D.C. 1949).

127. *Ibid.* It should be noted here that the NASD rules of procedure provide that appeal to the Board of Governors automatically operates to stay the order of the District Committee just as § 15A(g) of the Exchange Act provides that appeal to the SEC automatically stays enforcement of the Board of Governors orders. Stay of the SEC order pending review is discretionary with the Court of Appeals.

Yet the caveat placed on this rule by the court — “an appropriate subject with which this Court . . . may deal” — makes plain that upon a showing of, for example, denial of due process in the Association proceedings, the federal courts will intervene.

A California District Court of Appeal has also applied the exhaustion of administrative remedies rule as a ground for denying relief in *Rudolph v. Fulton*.¹²⁸ There, a member of the NASD brought a damage action against the Association for loss of business, property and life¹²⁹ on the grounds that the disciplinary proceedings brought against him were intended to harass him and that the proceedings were themselves unlawful and unfairly conducted. Without waiting for a decision by the District Committee on remand from the Board of Governors,¹³⁰ member Rudolph brought the instant damage action. The alternative, and apparently primary, ground for decision in the Court of Appeal, was exclusive federal jurisdiction over “remedies provided by the Securities Exchange Act.” Reasoning that the Exchange Act provides for SEC review of Association disciplinary action against members¹³¹ and for judicial review of SEC decisions in the Circuit Courts of Appeal,¹³² the court said:

Therefore, if plaintiff is entitled to any relief because of the alleged acts of the defendants in prosecuting him before the NASD, such relief can be obtained only in the federal Circuit Court of Appeals.¹³³

Similarly, the New York Supreme Court, although conceding “some merit” to the contention of the NASD members that they would be prejudiced at the Committee hearing by joinder of charges against

128. 178 Cal. App. 2d 339, 2 Cal. Rptr. 807 (1960).

129. Loss of life on the theory that because of actions of the NASD the plaintiff member was unable to give his twelve-year old son parental attention, wherefore the son committed suicide. (2 Cal. Rptr. at 809).

130. The decision, subsequent to entry of judgment in the trial court, was to expel Rudolph. The earlier decision ordering expulsion by the District Committee had been remanded by the Board of Governors for insufficient evidence to support the decision.

131. Section 15A(g), Exchange Act.

132. Section 25, Exchange Act.

133. 2 Cal. Rptr. 807, 809 (1960).

Subsequently, Rudolph brought another action in damages against the NASD which a different District of the California Court of Appeal declared to be “unintelligible.” The court, however, affirmed the trial court’s granting of a demurrer to the complaint after construing the theory of action as follows:

It seems that the statements set forth (in the asserted first cause of action) indicate an attempt to allege that although the defendant [NASD] is a non-profit corporation under state laws, it has been conducting a profit-making corporation under federal laws, and that, by reason thereof, the plaintiffs have been damaged. . . . The allegations seem to indicate that plaintiffs commenced this action merely as members of the public to recover damages by reason of the alleged failure of defendant to conduct its business in accordance with law.” (*Rudolph v. NASD*, . . . Cal. App. 2d . . . , 15 Cal. Rptr. 685, 686-7 (1961)).

them, denied injunctive relief, holding, “. . . this matter falls within an area pre-empted by the federal jurisdiction.”¹³⁴ Taken together, these decisions of the state and federal courts seem to apply a primary jurisdiction notion to federal administrative power over suits involving the NASD, unless there is some extraordinary ground for interference, which ground (despite its extraordinary nature) is open only to the federal courts. Yet the logic of this conclusion is not ineluctable. Certainly the *Rudolph* cases in California provided no fair test of a State court's willingness to interfere in NASD proceedings, and the New York court's acceptance of the *Rudolph* rule in *Barnett* seems to have come about without any close examination of the reason for the rule. Also, even putting aside the effect of the court's dictum in *Otis & Co.*,¹³⁵ the willingness of the District Court there to look closely into the facts of the case to determine the “appropriateness” of the subject for court action seems to indicate that when a more clear-cut situation appears, judicial relief will be granted without hesitation.

The importance of timeliness in an appeal to the Board of Governors by an aggrieved party is shown in *Royal Securities Corp. and John B. Milliken*,¹³⁶ where the member had failed to appeal an adverse decision by the District Business Conduct Committee within fifteen days, as provided by the rules.¹³⁷ Rather, twenty-one days after the decision he requested an extension of time of the Board of Governors in which to perfect his appeal. The extension was refused and the Board declined to review on its own motion. On appeal to the SEC it was held:

The NASD's rules relating to internal review, which we approved, do not contravene Section 15A(g) of the Act as applicants contend. It is clearly proper to require that a statutory right to review be exercised in an orderly fashion, and to specify procedural steps which must be observed as a condition to securing the review.

[The] applicants' failure to exhaust their remedy of review within the NASD pursuant to its rules precludes our review of the disciplinary action taken.¹³⁸

Although the SEC finds support for this position in the Administrative Procedure Act,¹³⁹ it is plainly arguable that strict enforcement

134. *Barnett & Co. v. NASD*, 202 N.Y.S.2d 136, *aff'd* 204 N.Y.S.2d 79 (1960).

135. *Supra*, pp. 623-24.

136. 36 S.E.C. 275 (1955).

137. *Supra*, note 124.

138. *Supra*, note 136, at 277.

139. 5 U.S.C. § 1001 (1958) *et. seq.*, esp. §§ 1007(a) and 1009(c).

of a rule for the time of filing an appeal is inconsistent with the nature of the proceedings before the NASD.¹⁴⁰ There is no argument to be made here in terms of crowded dockets in view of the educative function of Board review and the willingness of the Board to call up cases, *sua sponte*, to perform that function. Similarly, since the major purpose of the Association is to enforce "just and equitable principles of trade," a member charged with acting in a contrary fashion should be given a fair opportunity to draw on the Board's nation-wide expertise as to what practices are, and what are not, "just and equitable." At the least, it can be said that a fifteen day limit on the time for filing appeals is too short.¹⁴¹

The power of the Board of Governors on review encompasses not only the right to cancel, reduce or modify the punishment imposed by the District Committee but also the power to increase the penalty or impose one *ab initio*. Three basic limitations exist, however — one jurisdictional in nature — on the power to impose or affirm a penalty. First, the Board may not impose or affirm a penalty on grounds other than those relied on by the District Committee below. Accordingly, in *Managed Investment Programs*,¹⁴² the SEC set aside a Board penalty imposed on the ground of handling business while not registered as a representative. The basis for the decision was that the District Committee had predicated its finding of a violation on the ground that the individual in question had breached an obligation to his former employer in not reporting the transactions to, and handling them through, the employer firm. Second, the penalty of suspension may not be imposed for an indefinite period, as where the Board had ordered a member suspended until it should pay for certain securities.¹⁴³ Such an order is *per se* invalid. Third, and this in the nature of a limitation on jurisdiction:

The NASD is not the proper forum . . . to decide the private contract rights between the parties; its function under the Act and its rules is to determine whether a member's conduct violates ethical standards of "commercial honor and just and equitable principles of trade."¹⁴⁴

140. See note 112, *supra*.

141. Section 15A(g) grants sixty days for filing with the SEC; the usual period in the court systems is ninety days.

142. *Supra*, note 117.

143. *Lerner & Co.*, 37 S.E.C. 850 (1957).

144. *Id.* at 855. See also *Matter of NASD*, *supra*, note 56 at 438 and *Samuel B. Franklin & Co.*, 38 S.E.C. 113 (1951). In the latter case, the SEC extended this rule to cover its own jurisdiction saying (at 116):

[I]t is not our function, or that of the NASD . . . to decide private contract rights between the parties. . . . [T]he question presented . . . is whether the member's conduct in question violates standards of fair dealing.

Therefore, the Board of Governors was without power to order the member to perform his contract (by accepting delivery of certain shares of stock and paying for them within thirty days) on pain of suspension until performed.

Securities and Exchange Commission.

It is expressly provided in section 15A(g) that the SEC shall have the power of appellate review over any disciplinary action taken by a registered securities association against any member, either on appeal by the aggrieved member or on its own motion. We have already seen the importance of this power in finding the entire delegation of power constitutional.¹⁴⁵ The procedure for SEC review is basically set out in section 15A(h) of the Exchange Act,¹⁴⁶ but decisions by the SEC have put some gloss on the terms of that section.

A new, but relatively important, condition on the right to review by the SEC is the amendment of SEC Rule X-15Ag-1¹⁴⁷ which requires the applicant for review to file a brief or statement in support of his petition setting forth the basis of the appeal and the relief sought.¹⁴⁸ The power to dismiss summarily a petition for failure to file such a supporting brief or statement has already been exercised in one case.¹⁴⁹

With regard to evidentiary matters the SEC has ruled:

The NASD's interpretation and application of its rules are entitled to great weight by the Commission . . . its interpretation should certainly not be disturbed where, as here, it is consistent with decisions of this Commission involving similar situations.¹⁵⁰

In addition, the SEC has narrowly limited the right to introduce evidence in the review proceeding which was not of record in the NASD proceedings, despite the power, under section 15A(h), to consider "such other evidence as it may deem relevant." The general rule is stated in *Herrick, Waddell & Co.*:

145. *Supra*, pp. 620-22.

146. Of critical importance is the condition that the SEC may exercise its review power only if affirmative disciplinary action is taken by the NASD. See note 100, *supra*.

It should be noted, however, that the Commission has independent power, under § 15 of the Exchange Act, to take disciplinary action against brokers and dealers registered with them, including the power to expel them from the NASD.

147. This Rule, promulgated under Section 15A(g) of the Act, further delineates the procedure to be followed in petitioning the SEC for review of an NASD decision. The Rule also codifies the *Herrick, Waddell* rule on the admissibility of new evidence before the SEC. (See, *infra*, pp. 632-33).

148. Exchange Act Release No. 6606 (1961).

149. Stanford Corp. and George W. Stanford, Exchange Act Release No. 6655 (1961).

150. R. V. Klein Co., *supra*, note 92 at 149.

In general . . . 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.¹⁵¹

In the subsequent decision setting aside the NASD action against Herrick, Waddell, the SEC took the unusual course of remanding the case to the NASD for the admission of additional evidence in lieu of bringing in the evidence before the Commission, saying:

We have concluded that it is more in keeping with the legislative scheme for supervised industry self-regulation embodied in Section 15A that the NASD itself undertake to cure the inadequacy of the evidence presented by it and the errors made in relating the evidence to its rules as interpreted by it.¹⁵²

Recently, the rationale of the SEC rule for refusing to admit additional evidence unless it could not be presented in the NASD proceedings, was restated as being a means not "to impair the efficacy of the proceedings before the NASD."¹⁵³ Upon first reading this rationale for limiting the admissibility of additional evidence, the skeptic will ask how the admission of further evidence before the SEC could impair the efficacy of NASD proceedings. The rationale for remand to the NASD when additional evidence is needed provides the hint to answering the skeptic's question: the primary responsibility for regulation of NASD members is vested in the Association; therefore, members charged with breach of the established rules, as well as the Association itself as complainant, should be impelled to present fully their positions as to just and equitable practice in order that the Association may fulfill this primary responsibility.

The nature of the review power exercised by the SEC in these cases has been best stated in the dissenting opinion of the Public Service of Indiana cases:

Our role under Section 15A(h)(1) is an unusual one for a reviewing body because we are determining whether certain con-

151. 23 S.E.C. 301, 303 (1946). See also R. A. Holman, Exchange Act Release No. 6631 (1961).

152. Herrick, Waddell & Co., *supra* note 111, at 449. Note that it was the Association here, and not the member, who sought to adduce additional evidence before the Commission.

The SEC also followed the remand procedure in an unreported case where a member, charged with making unsuitable purchase recommendations to his customers, was prevented from introducing, at the NASD proceedings, letters sent to the customers advising against such trading and refusing to conduct the transactions for them. On remand, the Board of Governors dismissed the complaint. (See, 26 SEC ANN. REP. 120, n.86 (1961)).

153. Gerald M. Greenberg and Robert Leopold, CCH Fed. Sec. L. Rep. ¶ 76,684 (1959), *appcal dismissed*. Exchange Act Release No. 6320 (1960).

duct is consistent with just and equitable principles of trade, not whether it violated law . . . that is to say, we are applying to the NASD action in disciplining its own members certain limited tests specified in the statute. Hence I think it is a mistake to deal with such problems as if they were problems of law violation.¹⁵⁴

We have already seen above that NASD and SEC action is taken with regard to principles of trade and standards of fair dealing rather than with regard to private contract rights.¹⁵⁵ This conception of its role in reviewing NASD disciplinary action accords with the scope of regulatory power it concedes to itself and the NASD and, more importantly, with the role of an administrative agency as one of filling up the blanks in the legislative grant of power.

The scope of SEC review was declared by the Second Circuit in *R. H. Johnson & Co. v. SEC*:¹⁵⁶

We think that those provisions [§15A(h)(1)] call for (1) *de novo* findings by the Commission; (2) the hearing by the Commissioner of further evidence if necessary; and (3) an independent decision by the Commissioner as to the charges and penalty.¹⁵⁷

The SEC, in turn, has held that it has power to look into the proceedings of the District Committee even if the issue was not preserved on appeal to the Board of Governors but is raised before the Commission:

We do not believe that the provision of internal review before the national committee forecloses [our] examination of the district procedure. The extent to which that procedure is an open issue before us depends, among other things, on the extent to which the facts show a lack of due consideration of the merits by the district committee and the extent to which proceedings before the national committee are curative of the errors below.¹⁵⁸

An example of the pragmatic need for such power (which is not to say that there is no theoretic need for it) appeared in a case where the Board of Governors had been equally divided on the merits:

154. *Matter of NASD*, *supra*, note 56, at 480.

155. *Supra*, note 144 and text *thereat*.

156. *Supra*, note 77, at 695.

157. The contrast between this court's view of the Commissioner's duty to hear additional evidence and the actual exercise of that duty, discussed *supra* p. 633, casts some doubt on the legitimacy of the Commission's practice in this area. Yet, if one agrees that the NASD ought to be primarily responsible for regulation of its members, there is little doubt that the Commission's rule is preferable. In addition, this statement by the court is purely *obiter dictum* since the scope of the SEC's review power was not at issue and, in any event, the Commission's Rule X-15Ag-1 was in all probability not called to the court's attention.

158. *Sherman Gleason & Co.*, *supra*, note 57, at 649.

The failure of the Board of Governors to elaborate its opinion or to indicate wherein it was unable to reach a decision . . . makes it necessary for us to rely entirely on the opinion of the District Committee in reviewing the proceeding.¹⁵⁹

Finally, in permitting the NASD to amend its By-Laws so as to bring individual representatives under the direct control of the Association, the SEC ruled: “. . . we have the same scope of supervisory power over NASD action respecting representatives as we do over its action respecting members”¹⁶⁰

The power of the SEC on review is more restricted than that of the Board of Governors in one respect — the SEC may not increase the penalty, as may the Board, but it may reduce or set aside a penalty if it is found to be “excessive or oppressive, having due regard to the public interest.”¹⁶¹ If the penalty is not found excessive or oppressive, the SEC dismisses the appeal.

Judicial Review.

In concluding this analysis of the procedural aspects of NASD proceedings, the scope of judicial review accorded appeals from SEC dismissals of appeals from Board of Governors decisions remains to be noted. Succinctly stated, the rule is that the court will “review the action of the SEC, not that of the NASD, . . . we consider errors in the proceedings of the NASD only if and to the extent that they infected the Commission’s action by leading to errors on its part.”¹⁶² Although this rule seems to mean that the Association is generally not subject to judicial scrutiny even in those cases which go all the way to the circuit courts of appeal, it is clear that this rule is not literally applied; in each of the cases reported the courts have in fact passed on the NASD rule in question as applied to the facts of that case. The apparent meaning of this broad statement, then, is that the courts will consider NASD rules and practices as they are, case by case, put in issue; but the courts will not attempt to determine, generically, what are and what are not “just and equitable principles of trade.” Surely this approach cannot be said to differ materially from that taken in review of the ordinary administrative agency.

159. Herrick, Waddell & Co., *supra*, note 111, at 439, n.1.

160. Matter of NASD, *supra*, note 59, at 518.

161. § 15A(h)(2), Exchange Act.

162. Klein v. S.E.C., 224 F.2d 861, 864 n.5 (2d Cir. 1955). Compare the SEC’s power to look through the Board of Governors proceedings and pass on those at the District level.

THE SUBSTANTIVE RULES OF FAIR PRACTICE

The NASD has adopted twenty-eight Rules of Fair Practice relating to the manner in which a member is to conduct his business. It is sufficient to note here that all of these rules sound in rule 1: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."¹⁶³ As written, this is a fairly innocuous rule, but surely it is also one subject to a wide divergence of interpretation. In considering the cases that have been appealed to the SEC it seems most convenient to divide them into three categories: (1) cases dealing with relations among fellow members of the over-the-counter fraternity and the Association; (2) cases dealing with a member firm's relationship with its employees; (3) cases dealing with sales relations with investors.

Intra-Fraternity Cases.

Undoubtedly the most important and best known case within this category is the one dealing with the Public Service of Indiana bond offering.¹⁶⁴ Stated simply, the problem there was that the NASD was attempting to impose penalties on member firms which had sold the bonds in question at prices lower than the stabilization price while participating in the initial distribution.¹⁶⁵ The public offering of these bonds ran into serious difficulty because of the events immediately preceding World War II, with the result that the distribution took much longer than was normal, and the price of the bonds broke almost immediately upon initiation of the offering. Due to the price fluctuations downward, 107 members of the NASD, acting both as underwriters and as part of the selling group of dealers, sold bonds at prices below the agreed distribution price. Over one hundred complaints were filed in the various districts, in seventy of which District Business Conduct Committees imposed modest fines. The Board of Governors called these seventy cases up for review, plus several which had been dismissed, and affirmed the imposition of fines. Then the SEC, on its own motion, called up for review six cases deemed to be representative of the entire number. The issue on appeal was whether the NASD could, by means of the Rules of Practice, enforce the contractual price maintenance term intended for purposes of efficient distribution. The SEC held that it could not and set aside the fines.

163. NASD Manual D-5. The close similarity between this language and that of Section 15A is obvious.

164. Matter of NASD, 19 S.E.C. 424 (1945).

165. For a thorough discussion of "stabilization" see 3 LOSS, SECURITIES REGULATION, ch. 10B (2d ed., 1961).

In its holding, the SEC narrowly limited itself to the very issue stated — in fact, it stated that if squarely presented with the issue it would not prohibit price maintenance provisions just as it did not prohibit stabilization via open market purchases — but found the NASD interpretation improper in two respects. First, it constituted an attempt on the part of the Association to enforce private contract rights by way of disciplinary proceedings, a practice which we have already seen is *ultra vires* the power of the NASD and the SEC.¹⁶⁶ Second, such an enforcement policy would run directly counter to that portion of section 15A(b)(7) which requires that association rules not “impose any schedule of prices.” It was also noted, in rejoinder to an NASD argument, that enforcement of price maintenance via disciplinary proceedings was not necessary in view of the fact that court enforcement of the respective contract rights was available. A dissenting commissioner felt that breach of such an agreement was conduct inconsistent with rule 1, but he added such conditions to his proposed rule that it seems clear, on the facts of this case, that there was no violative behavior.¹⁶⁷ This case is also interesting inasmuch as it underlines the chief inducement to membership in the NASD. Section 15A(i) of the Act expressly prohibits any association member from dealing with any nonmember except at the same prices and on the same terms and conditions as with a member of the general public, whereas a “dealer’s discount” or special terms may be granted a brother member of the association.

As a result of this section it is virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of important size. Since the major underwriting firms of the country are members of the NASD, non-member firms are practically excluded from participating in this type of business.¹⁶⁸

166. *Supra*, note 144 and text *thereat*.

167. One of the conditions was that the breach be “one for which fair justification or equitable excuse does not exist.” (Matter of NASD, *supra*, note 164, at 482). Clearly, the break in the market provided a “fair justification or equitable excuse.”

168. *Supra*, note 164, at 441. Of course, the same statutorily permitted price discrimination maintains in the sale of securities other than in an initial distribution.

The anti-trust ramifications of these stabilization agreements was argued before the Commission here also. (The Dept. of Justice was permitted to intervene in these proceedings as an interested party, over the objection of the NASD (15 S.E.C. 577). All the commissioners agreed that these agreements were not unlawful under the Sherman Act, the majority taking eighteen pages of the printed report (19 S.E.C. 446-464) to conclude that such agreements are not per se unlawful and the “reasonableness” of the agreement should be judged by:

... the size of the group in relation to the size of the issue, the suppression of competition in bidding or negotiating for the business, and the duration of a syndicate dictated by the manager and major underwriters.

See also, *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953).

Although outside the scope of this paper, it might be well to note that this statutory power of price discrimination under § 15A(i) has been exempted from the reach of the antitrust law by § 15A(n), according to the dictum of several cases.

This category of cases also includes the other two cases where NASD penalties were set aside because there was an attempt to enforce private contract rights. In the first, *Lerner & Co.*,¹⁶⁹ Lerner had agreed to purchase a large block of shares from another member firm on condition that he get the shares along with their proxies so as to obtain representation on the board of the issuer. The selling firm procrastinated in final delivery until the day after the issuer's annual stockholders' meeting whereupon Lerner refused to take delivery of the shares. Complaints were filed against both the selling firm and Lerner in their respective districts. A joint hearing was held in a neutral district where the selling firm was censured, fined \$1,000 and assessed costs. Lerner was only censured. Upon remand to the respective home districts, Lerner's district concurred in the censure, but the selling firm's district declined to follow the decision of the third district. The Board of Governors, reviewing on its own motion, reduced the selling firm's fine to \$500 and ordered Lerner to pay for the shares (6000 at 28; 100 at 26¼) within thirty days or face suspension from membership until he did pay. As noted above, the SEC held this order invalid per se because it involved a suspension for an indefinite period. Furthermore, the NASD order was deemed improper as an attempt to enforce private contract rights through a disciplinary proceeding.

In the second case,¹⁷⁰ Samuel B. Franklin & Co. had sold and delivered 500 shares to another member firm which was a specialist in the security. Some twenty days later the buyer demanded that Franklin take back the shares since they were "old" ones which had been subject to a "reverse split," a fact which Franklin was not likely to know since the company was not a specialist in the security. Franklin did take back the shares and offered to rescind the entire contract. The buyer refused because there had been a rise in the market price of the security, but suggested that Franklin not replace the shares immediately since they were over-priced, which suggestion Franklin followed. When the price continued to rise and there was an eight per cent stock dividend, the buyer firm finally "bought-in" 540 shares to cover the contract and filed a complaint, after renegeing on an earlier decision to

United States v. Socony-Vacuum Oil Co., Inc., 310 U.S. 150, 227 n.60 (1940); United States v. Morgan, 118 F. Supp. 621, 697 (S.D.N.Y. 1953); Silver v. New York Stock Exchange, 196 F. Supp. 209, 220 (S.D.N.Y. 1961)). Section 15A(n) provides:

If any provision of this section is in conflict with any provision of any law of the United States in force on June 25, 1938, the provision of this section shall prevail.

169. *Supra*, note 143.

170. See *supra*, note 144.

submit the case to arbitration. The District Committee found a violation of rule 1, censured Franklin and assessed costs; the Board of Governors affirmed the censure and further required that Franklin make good the loss to his buyer within thirty days or face further disciplinary proceedings. The SEC set aside the penalty on the grounds that there was no evidence that Franklin "sought to evade responsibility arising from the delivery of old certificates . . . [and thus his] conduct was not inconsistent with 'just and equitable principles of trade' within the meaning of the Rule."

The rulings in these three cases seem clearly to establish that the NASD, even when viewed as a private trade organization, is a strange beast. The Association lacks the power to force conformity on its members in either price or product; it may only establish minimum standards for customs and practices. But it may not enforce certain core practices, such as fulfilling contractual obligations, by requiring specific performance. And, finally, it must ever have in mind the "public interest" over and above the "trade" interest.

A major problem in the relationship between member firms and the Association is the failure of many members to maintain proper records. This is an affirmative duty imposed by Rule 21 of the Rules of Fair Practice which, although rarely cited in the SEC opinions, is the basis for finding many violations. A very recent decision of the SEC has stated the rationale of this rule as follows: "[Proper maintenance of current books] is a keystone of the surveillance of registrants and NASD members with which we and the NASD are charged in the interest of affording protection to investors."¹⁷¹

Member Firm — Registered Representative Relationships.

It is expressly provided in Article XV, Section 2 of the By-Laws of the NASD that no member firm of the Association shall permit any person to transact any branch of the business in any capacity unless such person is registered with the Association.¹⁷² This control over the individual representatives was acquired by the NASD in order to

171. Midland Securities, Inc., *supra*, note 106. The Court of Appeals for the Second Circuit, in *Boruski v. SEC*, *supra*, note 107, has recently upheld the SEC's dismissal of an appeal where the violation of the NASD Rules of Fair Practice was predicated in part on the member's failure to maintain proper books.

In the most recent case involving a failure to maintain proper books and records it appears that, even after entry of a consent judgment in an injunction suit brought by the SEC regarding the same acts of omission, a District Committee ordered expulsion of the member from the NASD. (Robert H. Davis d/b/a Colonial Investors, CCH Fed. Sec. L. Rep. ¶ 76,824 (1962)). The Board of Governors, however, reduced the penalty to a six-month suspension and the SEC, in turn, to a twenty-day suspension, in view of "the measures taken by applicant to prevent future violations and the restriction of his activities which will reduce the extent of record keeping involved."

172. NASD Manual C-53.

carry out more effectively the purposes of section 15A by imposing direct responsibility on the individual employee for carrying out the principles of fair dealing.

*Managed Investment Programs*¹⁷³ is the only review case where a penalty was imposed for a representative's transaction of business while unregistered. In that case the individual was between jobs, having just left the employ of one member firm and awaiting registration with the Managed Investment Programs firm (of which he became the principal partner), when two customers who had dealt with him in the context of his former employment requested that he transact certain purchases for them. He completed the transactions for them through the agency of the Programs firm and received commissions for the sales. The District Conduct Committee found that he had violated rule 1 in failing to report the buy orders to his former employer and revoked his registration; the Board of Governors reduced the penalty to censure and imposed a \$300 fine on the ground that he had violated the registration requirement. The SEC did not pass on the substantive merit of finding a violation, but set aside the penalty on the procedural ground that the Board had imposed a penalty on grounds not raised below.¹⁷⁴

Although the necessity for NASD control over individual representatives is obvious — and thus the principle, if not the application to the instant facts, of the Board of Governors decision is proper — it seems doubtful whether the principle enunciated by the District Committee in this case is desirable. Once a representative terminates an employment relationship in order to work for a different firm, there seems to be no satisfactory reason for preventing him from servicing investors whom he first contracted at the old firm, even conceding that "stealing" customers is a serious problem for many firms when employees leave. Furthermore, the relation between some investors and their "broker" is a very personal one so that the customer is better protected by dealing through this trusted representative who is between jobs and thus unregistered, than if he were remitted to a registered stranger. That the investors here sought out the representative in question may be the best evidence of the personal trust placed in one's broker.

Failure to register individuals as representatives is also a common cause of violations of the above By-Law. Two recent decisions on this problem have turned on the same factor. A 1949 resolution of

173. *Supra*, note 117.

174. *Supra*, p. 631.

the Board of Governors stated that "wilful" failure to register representatives as required by Article XV of the By-Laws was a violation of rule 1.¹⁷⁵ In *Boren & Co.*, it appeared that the member firm had failed to register a number of representatives due to the negligence of an experienced employee. The District Conduct Committee found no "wilfulness" in the failure to register, but nevertheless found a violation on the grounds that wilfulness was unnecessary; the Board of Governors affirmed. The SEC, however, set aside this decision saying, "The NASD cannot dispense with a requirement which it has itself prescribed for finding a violation of its rules in this respect."¹⁷⁶ Two months later, in *Midland Securities, Inc.*,¹⁷⁷ the SEC set aside another NASD decision on identical grounds.

Rule 27 of the Rules of Fair Practice imposes the affirmative duty on member firms to supervise the activities of registered representatives associated with the office.¹⁷⁸ Thus, in *Graham & Co.*,¹⁷⁹ a violation was found by the NASD, and affirmed by the SEC, where salesmen's purchase orders were not endorsed by an executive of the firm, in contravention of rule 27(a). In another case, *Earl L. Combest*,¹⁸⁰ which arose when rule 27 contained the word "salesman" rather than "registered representative" as it now does, the appellant argued that since the violations were perpetrated by his copartners in the firm he should not be disciplined under the rule. In affirming a \$2,500 fine (but setting aside his suspension) the SEC ruled:

[T]he fact that B.E. Prugh and Coenx had official titles and owned an interest in the member [firm] did not relieve the member of responsibility under Section 27 with respect to the transactions effected by those persons as salesmen; . . . applicant, as the chief executive officer who was daily active in the business, was charged with that responsibility . . .¹⁸¹

It is clear from this decision that all individuals who act in a selling capacity are subject to the same rules as the newest salesman in the office. The appropriateness of this uniform regulation is especially apparent here, since it usually takes some experience in the securities

175. This resolution was promulgated under the authority of the Board to make and issue interpretations of the Rules of Fair Practice. NASD Manual C-40, By-Laws, Article VII, Section 3(a).

176. *Boren & Co.*, *supra*, note 76. It is interesting to note, however, that by virtue of the employee's being "experienced," application of ordinary tort and contract notions would make this failure to register "wilful."

177. *Supra*, note 106.

178. NASD Manual D-18 and D-19.

179. 38 S.E.C. 314 (1958).

180. 35 S.E.C. 623 (1954).

181. *Id.* at 626.

business before transactions intentionally harmful to an investor's interest can be carried off successfully.

The scope of this duty to supervise is seen in two cases. In one, *Gilbert Parker*,¹⁸² it appears that the individual whose registration was revoked by the NASD was an absentee secretary-treasurer. The firm had formerly been subject to proceedings by the Association for several violations relating largely to improper hypothecation of customer's securities, other forms of financing violations, and exceeding the aggregate indebtedness rule. In accordance with the minor violation procedure, the firm, Parker and other officers sent pledges to the District Conduct Committee that there would be no further violations. However, Parker continued to be absent from the office and the firm again exceeded the 2,000 per cent aggregate indebtedness rule. NASD proceedings were initiated, resulting in revocation of registration for Parker and the other officers. On appeal, Parker argued that due to his absence from the daily operations, and because of the express assurances given him by the operating executives, his registration ought not to be revoked. The SEC summarily dismissed this contention:

. . . Parker was grossly remiss in his obligation in not keeping fully informed as to the practices of the company to insure that there was compliance with the net capital and other requirements applicable to the business.¹⁸³

In the second case on the scope of the duty to supervise, *R.H. Johnson & Co.*,¹⁸⁴ the member firm was a large New York firm with branch offices in Boston. A new representative, taken on in the Boston office, brought with him several accounts, in one of which he subsequently traded excessively.¹⁸⁵ The District Business Conduct Committee found that the individual representative, the firm, and two partners in the Boston branch office were in violation of rule 1 and imposed penalties; the Board of Governors reduced the penalties of the Boston partners, affirmed the penalties as to the representative and the firm, and further found that the principal partner of the firm, who worked out of New York, was also in violation of the rule. On appeal to the SEC, it was argued by the principal partner that he ought not be subjected to discipline since the two Boston officers were partners and since he was rarely in the Boston office. In dismissing his appeal, the SEC held that "effective supervision by the New York office or

182. *Supra*, note 74.

183. 34 S.E.C. 385, 388 (1952).

184. 33 S.E.C. 180 (1952). For the subsequent history of the case see notes 76 and 77, *supra*.

185. For the meaning of "excessive trading" see *infra*, pp. 652-53.

Johnson over the activities of the Boston office was lacking."¹⁸⁶ The control exercised by the New York office was evidenced by the fact that all permanent books, records and accounts were kept there and the required approval of transactions was given in that office. Furthermore, "[Johnson's] responsibility would be more, rather than less, clear, if [the two Boston officers] held a partnership status. . . . [T]he supervisory functions of [the two officers] were limited and that fact together with Johnson's control of applicant [firm] are significant in determining whether Johnson was individually responsible for [the violations]. . . ." ¹⁸⁷

The implications of the decisions in these two cases are obvious: the duty to supervise employed representatives is not relaxed merely because the responsible officer of the firm has other duties in other places. That is to say, the standard of supervision required of the multi-office member firms is equally as high as that required of the two-or three-man office.

Finally, in *Earl L. Combest*,¹⁸⁸ the applicant representative admitted violation of rule 24 (which prohibits giving discounts or selling concessions to any one other than a fellow member) in paying about half of his commissions for transactions in the shares of a mining company to an officer of that company. The NASD, however, suspended his registration for two years and imposed a fine of \$2,500 on the basis of a violation of both rule 24 and rule 1. But the SEC, in setting aside the suspension, apparently found only a violation of rule 1 since it made no adverse findings as to rule 24. In any event, no matter on which rule the violation was predicated, it is clear that payment of commissions to one other than an association member is prohibited.

Relationships with the Investing Public.

In keeping with the purposes of the Maloney Act, the great majority of NASD disciplinary cases have predictably been concerned with transactions between an Association member and an investor. Similarly, most of these cases have turned on the question of what is a fair profit for a broker-dealer when he sells or purchases securities.

Soon after the NASD was registered, but before the Association had begun active enforcement of its rules, the SEC had before it what appears to be the first case where the quantum of profit (the

186. 33 S.E.C. 180, 186 (1952).

187. *Id.* at 185.

188. *Supra*, note 180.

mark-up or spread) was in issue. In *Duker & Duker*,¹⁸⁹ a firm had realized profits of thirty per cent and thirty-six per cent on transactions of \$1,506 and \$572 respectively. In addition to finding a violation of Rule X-15C1-4 — promulgated by the SEC under the Exchange Act — for failure to notify the customer whether acting as principal or agent,¹⁹⁰ the SEC laid down the following basic principle as to profits:

Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession. It is neither fair dealing, nor in accordance with such standards, to exploit trust and ignorance for profits far higher than might be realized from an informed customer. It is fraud to exact such profits through the purchase or sale of securities while the representation on which the relationship is based is knowingly false. This fraud is avoided only by charging a price which bears a reasonable relation to the prevailing price or disclosing such information as will permit the customer to make an informed judgment upon whether or not he will complete the transaction.

This opinion is not, of course, to be taken as a condemnation of all profits realized by dealers. Our decision is merely that a dealer may not exploit the ignorance of his customer to exact unreasonable profits resulting from a price which bears no reasonable relation to the prevailing price. The reasonableness of the profit charged can be determined only on the basis of the individual facts of each case.¹⁹¹

Rule 4 of the NASD Rules of Fair Practice¹⁹² further defines the principle as applicable to Association members: When acting as principal (dealer) in the transaction, "he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled

189. 6 S.E.C. 386 (1939). This was not a review of NASD proceedings (the decision permitting the Association to register had been handed down but four months before), but rather was an independent SEC proceeding brought under Section 15(b) of the Exchange Act.

190. 17 C.F.R. § 240.15c1-4 (1949). The firm had acted as agent (broker) for the customer in the sale of certain shares, had then used part of these proceeds to buy in shares in its own name as principal (dealer), and then re-sold the newly purchased shares to the customer's account at the stated profit margin.

Failure to reveal whether acting as principal (dealer) or agent (broker) is also a violation of Rule 12 of the NASD Rules of Fair Practice. (NASD Manual D-8). The Second Circuit has recently upheld the finding of a violation of this Rule where the member's compliance consisted of the statement in its letterhead, "Lic. Mutual Funds Investment Broker." (*Boruski v. SEC*, *supra*, note 107, at 740).

191. 6 S.E.C. 386, 388-89 (1939). The implied representation theory has since been expounded in numerous cases. See *e.g.*, *Charles Hughes & Co., v. SEC*, 139 F.2d 434 (2d Cir. 1943), cert. denied 321 U.S. 786, (1944).

192. NASD Manual D-6.

to a profit"; when acting as agent (broker) for the customer he shall not charge "more than a fair commission or service charge," taking into consideration the same factors. The first disciplinary proceeding taken to the SEC for review, *Sherman Gleason & Co.*,¹⁹³ involved, *inter alia*, a charge that rule 4 had been violated. The SEC, in dismissing the appeal as to this charge, ruled:

It would have been helpful on review if the NASD had expressed its reasons for rejecting Gleason's defences regarding his compliance with local business practices and the smallness of his annual net profit. We do not, in this case, attempt to construe the meaning of the NASD's fair price rule [Rule 4]. However, no matter what theory of the rule is adopted we think it clear that the NASD has ample power under it to discipline a member for charging prices bearing no reasonable relation to prevailing market prices.¹⁹⁴

At about the time the Sherman Gleason proceeding developed in the NASD, the Association was also circulating a questionnaire to its membership surveying customary mark-ups. Responses from eighty-two per cent of the membership showed that forty-seven per cent of the transactions were at a gross spread of not over three per cent and seventy-one per cent were at a gross spread of not over five per cent. These results were made known to the membership by a letter wherein the Board of Governors cited an interpretation of rule 1 which stated that it was deemed "conduct inconsistent with just and equitable principles of trade . . . to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security." The letter then went on to say:

. . . [T]he District Business Conduct Committees have been instructed to enforce [Rule 1] as above interpreted, having in mind the percentage of profit on which 71 per cent of the transactions above referred to were effected. In the case of certain low-priced securities, such as those selling below \$10, a somewhat higher percentage may sometimes be justified. On the other hand, 5 per cent or even a lower rate is by no means always justified.¹⁹⁵

Two weeks later a letter went out to the District Committees, the essence of which is contained in the following two paragraphs:

[W]hen transactions show a mark-up of over 5 per cent on the part of a member, it raises the question as to whether there is a violation of the Rule and interpretation. In such a situation, a

193. *Supra*, note 57.

194. 15 S.E.C. 639, 651 (1944).

195. Matter of NASD, *supra*, note 75, at 473, Appendix A.

duty is imposed upon the member to show to the satisfaction of the Business Conduct Committee that no violation has occurred.

Isolated transactions, where the spread or mark-up is in excess of 5 per cent, may warrant only informal inquiry or a precautionary letter but where practice is established, formal complaint procedure is the recommended course.¹⁹⁶

Several members of the Association appealed to the SEC against the establishment of the "5% Policy" on the grounds that it was a "Rule," or had the practical force and effect of a "Rule," and therefore was void since not adopted by affirmative vote of the membership. The SEC upheld the policy, declaring it was an "interpretation" of rules 1 and 4, and thus within the power of the Board of Governors, but also ruled that a mere showing of mark-ups in excess of five per cent would not make out a prima facie case of violation. The Commission indicated what additional factors should be taken into consideration in passing on the propriety of mark-ups:

Determination by the committees and by the board on review must be based on a consideration of all the pertinent factors, of which the percentage of mark-up is only one.

Others include consideration of the dollar amounts involved, market conditions in the particular security, the relationship between the member and his customer, and any unusual circumstances incident to the particular transaction.¹⁹⁷

In the first case to come up for review after the "5% Policy" went into effect, the SEC further limited its stringency.¹⁹⁸ In that case, it appeared that the member firm had taken mark-ups generally in the vicinity of seven to eight per cent, with one as high as eleven per cent, over cost — mark-ups in the same general range as other firms in the same neighborhood. The District Conduct Committee censured the firm and fined it \$250; the Board of Governors affirmed the penalty on the basis of an equal division of opinion. In its decision on the appeal, the SEC noted that the NASD rules "go beyond fraud," but that since the firm here had fully disclosed to its customers the mark-ups it was taking, there was no basis in fraud for finding a violation. Therefore, the only question was of the reasonableness of the mark-ups.

[W]hile an undisclosed mark-up which is not so excessive as to constitute fraud might nevertheless violate business ethics, it

196. *Id.* at 476-7, Appendix B.

197. *Id.* at 469-470.

198. Herrick, Waddell & Co., *supra*, note 111.

does not follow that the same mark-up, accompanied by full disclosure, is always a violation of business ethics.¹⁹⁹

[W]here it can be demonstrated that higher costs are due to special services performed by the member for the customer . . . it should be concluded that prices which exceed those charged by competitors not rendering such special services are not in violation of the NASD's rules if the excess bears a reasonable relation to the cost of the special services.²⁰⁰

In determining whether a mark-up is proper, . . . the type of business engaged in by the accused firm, the nature of its customers, the services performed, and the type of disclosure made are all relevant circumstances.²⁰¹

The SEC then set aside the penalty imposed on the firm on the grounds of the firm's disclosure, insufficient evidence adduced by the NASD, and special advisory services performed for customers.

Subsequent decisions by the SEC on the problem of fair prices have followed the same trend of examining every facet of the transaction in order to determine whether the mark-up was reasonable. One additional criterion which has been developed is that if the firm engages in "riskless trading," that is, it purchases securities only when it has a firm commitment to buy from a customer, then the mark-up must be kept low. For example, in *R.V. Klein Co.*, where the firm was taking fifty per cent mark-ups in the sale of oil royalties, most of which were purchased within five days of their sale, the SEC dismissed an appeal from the NASD decision expelling the firm. The Commission held that the prices charged were unfair in light of the relatively riskless nature of the transactions, the large dollar volume involved and the percentage of spread. Also, no special services or circumstances were shown as grounds for the mark-ups.²⁰² Similarly, in *Managed Investment Programs*,²⁰³ where the firm was buying the securities on the same day that they were re-sold, the SEC dismissed an appeal from the fine imposed by the NASD, on the ground that the transactions were riskless.²⁰⁴

199. *Id.* at 446.

200. *Id.* at 447.

201. *Id.* at 448.

202. *Supra*, note 92. The subsequent history of the *Klein* case is discussed *infra*, p.

203. *Supra*, note 117.

204. The SEC also clarified the "special services" factor in this case saying (37 S.E.C. 783, 787 (1957)):

Applicants have not shown any special services or other circumstances warranting the mark-ups taken. While Chadwick maintained close contact with the affairs of the companies whose securities were being sold and visited their office, plants, and officials, it does not appear that such activities entailed the incurring

In *Samuel B. Franklin & Co.*, the SEC, in dismissing the appeal, stated the facts of the case and holding on the "risk" point thus:

In the 606 transactions involving \$100 or more [in gross dollar amount], the mark-ups were 30% or more in 55 cases, in excess of 20% in 184 cases, over 15% in 303 cases, and over 10% in 444 cases. Furthermore, the mark-ups in many cases are based on applicant's cost on purchases of shares of the same stock on the same day as its sales. In many other cases the purchases were within a few days of applicant's sales, so that shares were held in inventory only for a short period, and applicant's transactions were without substantial risk.²⁰⁵

Here, though, as in other cases, the SEC declined to adopt a rigid five per cent policy for itself when it held: "We find that applicant's mark-ups . . . at least in those transactions in which they were greater than 20% clearly were excessive."²⁰⁶ A similar refusal to adopt such a policy appears in the *Midland Securities* case²⁰⁷ where the SEC concurred in finding violations where mark-ups of from 10.4% to 67% were taken, but, sub silentio, it set aside the finding of violations where the mark-ups ranged from 7.1% to 8.3%.

The factor of dollar volume of the transactions, mentioned above in the *Franklin* decision, also appears in *Mitchell Securities, Inc.*,²⁰⁸ where the Commission said: "while the per share price was low, the dollar amount of most of the transactions and of the mark-ups taken in them was not small," and, accordingly, the appeal was dismissed. The converse of this rule appears in *Boren & Co.*,²⁰⁹ where mark-ups of 10.8% and 25% were taken on \$533 and \$150 transactions respectively — the SEC found no violation.

A final, basic problem in the area of fair prices is what figure shall be used as the prevailing market from which to compute the mark-up in setting the price to the customer. It is settled now that the price actually paid is the proper base if the security is handled

of expenses sufficient to justify the imposition of additional charges on the customers. . . .

Boren & Co., *supra*, note 76, and *Graham & Co.*, *supra*, note 179, also state the obvious rule: "excessive expenses do not justify an excessive mark-up."

205. 38 S.E.C. 908, 911 (1959).

206. *Id.* at 912. It was on this ground that the SEC decision was upheld in *Franklin & Co. v. SEC*, 290 F.2d 719, 725 (9th Cir. 1961). The court held:

[T]here is no hard and fast "5 per cent rule" as complained of by petitioner. The Commission did not discipline him merely because his commissions were in excess of 5 per cent. It did find that his "mark-ups and mark-downs, at least in those transactions in which they were greater than 20% clearly were excessive . . ." The evidence amply supports the findings of the Commission.

207. *Supra*, note 106. See also, W. Edward Teague, Exchange Act Release No. 6759 (1962), involving mark-ups of from 7.7% to 40%.

208. *Supra*, note 105.

209. *Supra*, note 76.

in "riskless trading," generally, a *same day* purchase and re-sale. If, however, the member has retained the security in his inventory for a time, then the current quotations appearing in the "pink sheets" provide the base, rather than the price previously paid.²¹⁰ This latter rule, of course, protects the dealer who buys low, holds while the price is rising, and then seeks to sell. Where there is a declining market in a security, *Boren & Co.*²¹¹ indicates that the dealer must still base his price on current quotations and not on the price he paid for the security, although the "reasonableness" of the mark-up may be viewed more generously than in a rising market situation. This means that a dealer who "invests" by placing a security in his inventory cannot simply pass his errors in judgment, as to price movement in the market, on to his customers.

The NASD "5% Policy" is one of the most controversial issues regarding the Association. Indeed, some have argued that the philosophy of the allowable "spread" is but a device for imposing large-firm domination on smaller firms in the industry by way of the Association. This argument proceeds from the fact that most of the cases involve low-price securities where a maximum on mark-up may mean a net loss on the transaction when overhead, particularly salesmen's commissions, is figured into the cost of the security, whether the cost base itself be current quotation or same day purchase price. Added to this is the fact that a large-firm, doing a large volume of business in high-price securities, is better able to absorb losses, if any, on its business in low-price securities, whereas a smaller firm may well have insufficient turnover in the high-price securities to offset losses in its proportionately larger trade in low-price securities.

Putting aside the self-evident point that any good businessman is opposed to foregoing an immediate profit unless the prospect of long-range profit is relatively clear, (which may in large part explain the opposition to the 5% Policy as a whole), it still seems evident that the Policy is not a vehicle for discrimination against smaller member firms in view of two facts. First, from the time of initiation of the Policy to the present, the SEC has continually refused to accept any notion of inflexibility in a five per cent limitation on mark-ups.²¹² In fact, it has, in every case, set out criteria in addition to the quantum of mark-up which induced its finding that the transaction in question had violated the Rules of Fair Practice by virtue of the price charged.

210. The most recent statement of this rule appears in Maryland Securities Co., Inc., Exchange Act Release No. 6442 (1961).

211. *Supra*, note 76. And see note 204, *supra*.

212. Matter of NASD, *supra*, note 75 and text thereat; Samuel B. Franklin, *supra*, note 205, also note 206 and text thereat.

In sum, the test continues to be whether the price charged "bears a reasonable relation to the prevailing price . . . on the basis of the individual facts of each case."²¹³ Second, the NASD itself has declared that the 5% Policy "is a guide — not a rule,"²¹⁴ and has established seven other factors relevant to a determination whether the price charged is "reasonably related to the current market price of the security" or whether the commission charged is not unreasonable.²¹⁵ Accordingly, it seems highly doubtful that the Association is itself attempting to enforce a rigid rule of five per cent, to say nothing of attempting to use such a rule to discriminate against smaller firms.²¹⁶

Another, and more recently developed, controversy regarding NASD regulatory activity relates to the "free-riding" problem.²¹⁷ "Free-riding" is defined as "the failure to make a bona fide public offering, at the public offering price, of a security while participating in its distribution as a member of an underwriting or selling group."²¹⁸ The economics of free-riding are quite simple: if there is an unexpectedly great demand for a securities issue when it is first marketed, the price on the shares immediately goes above the public offering price at which it was agreed to be sold, that is, it becomes a "hot" issue. Those brokers and dealers, then, who are part of the underwriting group or selling group and who are allotted certain portions of the issue for purposes of distribution to the public, sell the allotted shares to their own trading account, or that of a relative or business associate, and ultimately, when the price for the new issue is well above the offering price, re-sell the shares to the public, thereby reaping a nice profit.

The Association, in an attempt to control this practice, has promulgated a far-reaching *Interpretation* of Rule 1 of the Rules of

213. *Duker v. Duker*, *supra*, note 189; text at note 191.

214. *Interpretation With Respect to Mark-Ups*, NASD Manual G-1 to -6.

215. *Ibid.* The seven factors are: (1) the type of security involved; (2) the availability of the security in the market; (3) the price of the security; (4) the amount of money involved in the transaction; (5) disclosure; (6) the pattern of mark-ups; (7) the nature of the member's business. (This last refers to special services performed for certain types of customers, not to the size of the office.)

216. The paucity of appeals to the SEC is one factor indicating the propriety of this conclusion. As of Nov. 30, 1958, 1,203 complaints had been filed with district committees, leading to 271 appeals to, or reviews, by the Board of Governors and to twenty-six appeals to the SEC. (NASD Report 22, Appendix 4(a-2)). In addition, the evidence in other areas of NASD practice (see, *e.g.*, the discussion of the duty to supervise, *supra*, pp. 642-43) is plainly contrary to any notion of discrimination against smaller firms. And, finally, since election votes are allocated to firms and not to individual representatives (see, *supra*, p. 616), if these were such discrimination it would surely have been corrected by now in the election of new committeemen and board officers.

217. "Free-riding continues as perhaps the most important new disciplinary development before us — and certainly one of the most difficult." (NASD Report to Members 7 (1959)).

218. *Interpretation with Respect to "Free-Riding and Withholding,"* NASD Manual G-23 to 26.

Fair Practice,²¹⁹ which prohibits placing *any* of the securities (1) in the member's own account, (2) in that of a business associate or member of the immediate family, or (3) in an account in which any such person has a beneficial interest, if the member "has unfilled orders from the public . . . or has failed to make a bona fide public offering of the securities. . . ." The member may, however, sell the securities to an account of one of the persons named above if he can show that they were sold "in accordance with [the buyer's] normal investment practice *with the member* and that the aggregate of the securities so withheld and sold is insubstantial and not disproportionate in amount as compared to sales to members of the public."²²⁰ (Emphasis added.) In the only case appealed to the SEC to date relating solely to the NASD free-riding *Interpretation*, it was the "disproportionate in amount as compared to sales to members of the public" language that affected the member firm.²²¹ There, the firm sold 26.6% of its allotment as a member of the selling group to its employees' profit-sharing retirement plan. Relying solely on this fact,²²² the NASD imposed a \$500 fine. The SEC dismissed the appeal, concurring with the Association's position that the "normal investment practice" of the member firm is irrelevant when the firm withholds for its own use a disproportionate share of the issue.

Any doubt as to the propriety of, or necessity for, this type of regulation by the NASD is settled upon noting the Association's declared rationale:

The failure to make a bona fide public offering when there is a great demand for an issue can be a factor in artificially raising the price. Not only is such failure in contravention of ethical practices, but it [*sic*] impairs public confidence in the fairness of the securities business.²²³

In sustaining the NASD decision in the *First California* case,²²⁴ the SEC declared the effect of such withholding to be:

219. *Ibid.*

220. *Ibid.* The definition of "normal investment practice" for the purpose of this *Interpretation* expressly excludes "a practice of purchasing mainly 'hot issues'."

221. *First California Co.*, CCH Fed. Sec. L. Rep. ¶ 76,773 (1961).

In one other case, Leonard Zigman, Exchange Act Release No. 6701 (1962), the SEC sustained the suspension of a representative for twelve months where he had withheld for his own benefit some portion of the employer firm's share in a distribution. The chief ground of violation in the case, however, was that the representative had maintained a trading account with the employer firm under a fictitious name whereby he could conceal his identity when engaging in trading.

222. The actual profit to the employees' retirement plan on re-sale of the securities was a little under \$225, although at one time there was a paper profit of \$1,600.

223. *Interpretation with Respect to "Free-Riding and Withholding," supra* note 218.

224. *Supra*, note 221 and text thereat.

. . . not only to give to the insiders the opportunity for a profit on the shares withheld . . . but also to restrict the supply and tend to raise the market price further and enable the insiders to realize an increased profit upon subsequent sale of the shares retained by them.²²⁵

One final general category²²⁶ of inequitable trade practices dealt with by the NASD is breach of a quasi-fiduciary duty owed the customer by failure to protect his interest in conducting transactions in his account. One rubric for this sort of violation, "excessive trading," is exemplified in *R.H. Johnson & Co.*²²⁷ There, a registered representative effected 648 transactions in the accounts of a widow and her daughter amounting to a gross dollar volume of over a million dollars and a paper loss to the account of better than \$26,000. In addition, the securities acquired in 208 of the 348 purchase transactions were re-sold within six months; one-third of the purchases were made between a dividend declaration date and the ex-dividend date so that the customers were led to believe that they were achieving a net gain in the trading by receiving this "income." The Board of Governors affirmed the District Committee's revocation of the representative's registration on the ground that he had violated Rules 1 and 2 of the Rules of Fair Practice by inducing trading in the account which, in view of the financial resources and character of the account, was excessive in volume and frequency.

A less spectacular example of the same practice, in terms of dollar amount involved, is *First Securities Corp.*,²²⁸ where the gross volume of "churning" in an elderly widow's account was close to \$293,000,

225. The NASD has just embarked on an investigation into another aspect of securities distributions by establishing, on December 26, 1961, a Committee on Underwriting Agreements to review "arrangements between issuers and underwriters in connection with the offering of securities of unseasoned companies" to determine whether "the compensation received by underwriters for marketing these securities was unfair and unreasonable." Relevant factors in measuring the reasonableness of the underwriters' compensation include: (1) the nature of the underwriting agreement (best efforts, all or none, or firm commitment); (2) receipt by the underwriter of stock warrants or options; (3) allowance of expenses to the underwriter.

226. A miscellany of cases involving violations of the Rules of Fair Practice in addition to those falling within the categories discussed include: *Graham & Co.*, *supra*, note 179, where the firm violated Rule 13 in failing to disclose that the firm and the issuer of the security were under common control; *Sherman Gleason & Co.*, *supra*, note 57, where the firm commingled securities owned by it and others owned by customers in a single hypothecation; *Boren & Co.*, *supra*, note 76, where a certain sales literature, not filed with the NASD as required by the Rules, extolled the virtues of a certain investment but failed to reveal the risks; *Gordon M. Copp*, *supra*, note 121, where a representative caused a member firm to execute purchases for certain accounts without the authorization of the owners of those accounts; *Bennett-Manning Co.*, Exchange Act Release No. 6632 (1961), where the firm failed to comply with the net capital rule.

227. *Supra*, note 184.

228. Exchange Act Release No. 6497 (1961).

resulting in a paper loss of about \$2,000. In sustaining a sixty-day suspension of the employer firm for failure to supervise adequately the representative who did the actual trading, the SEC particularly noted that the customer "was substantially dependent on the income from her investments, was uninformed concerning securities matters, and relied completely on the advice given her by [the representative]." Finally, in *Thomas Arthur Stewart*,²²⁹ the firm, with the cooperation of the two customers whose accounts were involved, developed a "get-rich-quick" scheme whereby, dealing only in the shares of open-end investment companies, the shares would be redeemed almost immediately after they went ex-dividend and the proceeds then re-invested in the shares of a company about to declare a dividend. (Stewart got as his commission about six per cent of the purchase price of the shares.) The result of the scheme was that one customer showed a gross loss for the year's transactions of \$2,526 and the other lost \$1,400. In dismissing the appeal from a one-year suspension, the SEC accorded Stewart "the doubtful distinction of having originated the scheme" and held:

Both of these accounts disclose an amount of trading greater than that warranted by the nature of the securities dealt in or by the size of the accounts and the pattern of the transactions . . . indicates an illusory belief on the part of the customers that they were . . . [receiving] multiple dividends.²³⁰

The *Stewart* case also declares the other rubric under which this category of fiduciary duty cases is decided — "unsuitable recommendations to purchase" — which springs directly from the express terms of Rule 2 of the Rules of Fair Practice. The NASD bodies had based their finding of violation in *Stewart* on the fact that he had:

. . . recommended the purchase and sale of the shares without having reasonable grounds for believing that the recommendations were suitable for such customers on the basis of "facts disclosed by such customers as to their security holdings and as to their financial situation and needs."²³¹

229. 20 S.E.C. 196 (1945).

230. *Id.* at 202.

231. *Id.* at 201. The inter-quoted portion is from Rule 2 of the Rules of Fair Practice, NASD Manual D-5.

In *Boren & Co.*, *supra*, note 76, the firm had recommended and effected the purchase of open-end investment company shares for its customer in the apparent belief that such shares were "good for every one." The SEC concurred with the view of the NASD that this bona fide, but wrong, belief did not preclude finding a failure to give adequate consideration to the propriety of these shares as an investment for this customer. Accordingly, a finding of violation of the Rules of Fair Practice was sustained.

In *Standard Bond and Share Co. and William G. Stein*,²³² the firm, in 1949, caused the purchase of two bonds, at about half their face value, on the basis of a 1942 Standard & Poor report. In fact, the three most recent annual reports of the issuer showed that it had lost its principal asset and expressly warned that the regular payment of interest on the bonds, which had occurred in the past, should not deceive anyone as to the issuer's prospects. The report also stated that liquidation would provide insufficient funds to pay the bond principal. The SEC held, in its dismissal of the appeal from a thirty-day suspension and fine:

The customer to whom applicants recommended purchase of the bonds was entitled to a disclosure of the material facts necessary to determine whether the bonds were a suitable investment for her. . . . It is clear that the applicants should have ascertained and disclosed to the customer the facts . . . indicating the limited income and payment prospects of the bonds. . . .²³³

Similarly, in *Philips & Co. and Gerald G. Bernheimer*,²³⁴ where the member firm recommended speculative securities to customers of small means with "extravagant representations and glowing promises as to future profits," the SEC dismissed the appeal from a one-year suspension and laid down the following rule:

The test is whether Bernheimer [the representative] fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer's financial situation and needs. The record shows that Bernheimer knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist.²³⁵

Little, if any, comment is called for in this area of NASD practice. The cases where an obligation in the nature of a fiduciary's duty to disclose and to treat fairly has been imposed on Association members and representatives, clearly touch the essence of the function of the Association as intended by Congress. All the acts held violative of the Rules of Fair Practice here, not only the "free-riding" practice, are "in contravention of ethical practices" and impair "public confidence in the fairness of the securities business."²³⁶

232. 34 S.E.C. 208 (1952).

233. *Id.* at 211.

234. *Supra*, note 89.

235. 37 S.E.C. 66, 70 (1956).

236. See text at note 233, *supra*.

CONCLUSION

For the intrepid reader who has ventured this far in a study of the National Association of Securities Dealers the conclusion must be obvious: the Association is performing the job entrusted it by Congress in 1938 far better than might reasonably have been predicted at that time. Unquestionably, the Association has on occasion over-reached itself, as in the attempt to cause specific performance of contracts²³⁷ and in the first declarations about the 5% Policy.²³⁸ But then, what regulatory body, be it administrative agency or court, has not occasionally been called upon to assess the proper reach of its power? And, on the other hand, the evidence of a praiseworthy performance by the Association is heavy indeed. There seems to be no substantiation for any charge of Association discrimination against smaller firms, contrary to the popularly held notion of the necessary operation of a trade association.²³⁹ The number of appeals taken to the Board of Governors from District Committee decisions is small, about one in three,²⁴⁰ and the number of appeals to the SEC from the Board of Governors is even smaller, about one in ten,²⁴¹ clearly indicating satisfaction on the part of the membership, even those subjected to disciplinary proceedings, with the operation of the Association.²⁴²

Similarly, one is hard pressed to think of an instance where the public interest has been disserved by Association activity. But instances of regulation benefiting the public interest are numerous. One need only note the three discussed immediately above: control of mark-ups on the sale of securities; ensuring that public offerings of securities are public; and, preventing abuses of the trust imposed in a broker or dealer by an untutored investor. No less important are NASD achievements barely touched on in the above discussion, such as: examination of individuals engaged in the securities business; enforcement of the Federal Reserve Board margin requirements; and publication of daily quotations of bid and asked prices for industry and investor guidance. In a word, cooperative regulation of the over-the-counter securities industry, in the *public* interest, has been successfully achieved.

237. *Supra*, pp. 631-32; 636-39.

238. *Supra*, pp. 645-46.

239. *Supra*, pp. 649-50.

240. NASD Report 22, Exhibit 4(a-2). See note 216, *supra*. To reach this figure the total number of dismissals (349) is subtracted from the total number of complaints filed (1203) and the resulting figure set off against appeals to the Board (271).

241. *Ibid.*

242. In 1942 the Commercial and Financial Chronicle conducted a survey of broker and dealers in the over-the-counter market, both those who were and those who were not NASD members, as to their opinions about the Association and certain of its practices with results none too favorable to the Association. (See Cherrington, *loc. cit. supra*, note 38, at 756). It should be noted, however, that the sampling reported from that survey is not of the sort normally required for statistical reliability.