The Power of the Securities and Exchange Commission to Require Stock Exchanges to Discipline Members

Donald J. Dawidoff
THE POWER OF THE SECURITIES AND EXCHANGE COMMISSION TO REQUIRE STOCK EXCHANGES TO DISCIPLINE MEMBERS

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IN a 1971 legislative proposal,1 the Securities and Exchange Commission ("Commission") suggested that it be given the express power to review all disciplinary actions taken by self-regulatory organizations2 in the securities markets. Such disciplinary actions, sanctioned by the Securities Exchange Act of 1934 ("Exchange Act"),3 are a crucial aspect of the regulation of transactions in securities—the paramount goal of the Act. By means of disciplinary proceedings, the organizations charged with regulation of the securities business police conduct by member firms and registered representatives which is antithetical or harmful to the fair, open and productive purchase and sale of investment securities.

Two recent incidents of exchange discipline are illustrative. In the case of Phillips, Appel & Walden, Inc.,4 a brokerage firm was censured and fined $2,000 for what the New York Stock Exchange termed "repeated distribution of investment literature that improperly promoted the success of past recommendations."5 In the case of Charles H. Gross,6 the

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1. Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. (1971). The Study provides in relevant part: "[T]he Commission believes that the public interest would be better served if it had the authority to approve or disapprove any new rule proposal or proposed amendment, to supplement or to repeal an existing rule as well as to require amendments and supplements and the authority . . . to directly enforce the rules of the self-regulatory organizations. Such authority was previously recognized as being necessary and was included as part of the Commission's legislative program for 1941. Additionally, the Commission should be granted the authority to review all disciplinary actions taken by self-regulatory organizations upon appeal by any affected party or on the Commission's own motion and that this review authority should include the power to affirm, dismiss or modify any penalties in any manner it deems necessary or appropriate in the public interest and to insure the fair administration of discipline by the self-regulatory organizations." Id. at 41-42.

2. The self-regulatory organizations, which include the stock exchanges and the National Association of Securities Dealers ("NASD"), share regulatory power over the securities industry with the Commission.


5. Id.

New York Stock Exchange censured and levied a $25,000 fine against a former managing partner of the brokerage house of Newburger, Loeb & Co. and barred him from association with any clearing member firm without prior approval from the Exchange. The Exchange charged that Gross, who was also an allied member of the Exchange, had violated an exchange rule and a section of the Exchange Act "by virtue of his status as managing partner of the firm" during a five-month period in 1970 when the firm had 'continuously pledged customers' fully-paid-for securities as collateral for bank loans.' Rather than segregating customers' securities—something it was unable to do because it could not properly identify them—the firm was said to have frequently pledged such securities for bank loans during the operational crisis that affected Wall Street in 1970 and preceding years.

The question to be considered is in what manner and to what extent the Securities and Exchange Commission may itself initiate or review such disciplinary activity on the part of the industry bodies with whose regulation the Commission is charged. Should it possess the power to review particular decisions, as the recent legislative proposal has suggested? Should it proceed by the mediate step of requiring the initiation of such proceedings—or should it do both? Conceding that some action on the Commission's part is necessary for the maintenance of orderly, free securities markets, should this end be attained by judicial interpretation or by legislative prescription? It will here be advanced that granting the Commission power, through legislative enactment, to require the initiation of disciplinary proceedings on the part of the exchanges would buttress the existing disciplinary scheme and make for speedy, direct and responsible disciplinary proceedings as an adjunct to the cumbersome mechanism of Commission review.

I. THE ECONOMIC BACKGROUND

The securities business is the bulwark of our capitalistic system. Through the purchase and sale of securities, money is invested in the economy and risk capital is provided to entrepreneurs. When he purchases equity or debt in a business, the investor provides funds for the enterprise to build plants and machinery, produce or purchase goods and services and undertake expansion as well as maintain its position in the competitive world.

The use of organized market places such as the stock exchanges and over-the-counter markets encourages investment by assuring the investor that he can buy or sell at the best price available and that he will always

7. Id.
8. Id.
be able to redeem his investment at a fair price. Without such a promise of liquidity, the investor would be hesitant to place his savings in the securities markets and business would thus be deprived of a major source of its capital. This promise of ordered liquidity was not available before the creation of the Commission by the Exchange Act. While there had been rumblings of discontent before the Great Depression, it was that crisis which focused attention on the mishandling of investors' funds as well as the wild speculation which had helped to produce economic chaos.9 The securities industry had been a private club whose members scorned the average small investor and made little or no effort to promote his welfare. Certain crucial instances of abuse finally brought the house tumbling down, and in the aftermath the vast scheme of regulation now known as the Securities Acts was spawned.

There are twelve registered securities exchanges.10 As defined in the Exchange Act, an exchange is "any organization, association, or group of persons ... which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities ... and includes the market place and the market facilities maintained by such exchange."11 Typically, an exchange is created when groups of dealers and brokers12 band together after having become habituated to trading securities as a collective act. As the exchange becomes formalized, it may grow in size until it is a large and powerful organization. The general public customarily cannot purchase and sell securities on an exchange directly, but must act through "members" or third party non-member "brokers" who in turn act through members in effecting such transactions.13

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9. See generally 2 L. Loss, Securities Regulation 1166 (2d ed. 1961) [hereinafter cited by volume as Loss].
10. R. Jennings & H. Marsh, Securities Regulation 4 n.c (3rd ed. 1972). An exchange is generally defined as a place where business interests of a special character are brought together, and where contracts concerning them are made. Webster's New International Dictionary 889 (2d ed. 1957).
12. A "broker" is defined as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Id. § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1970). The Act defines the term "dealer" to mean "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." Id. § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1970).
13. The Exchange Act defines a "member" as "any person who is permitted either to effect transactions on the exchange without the services of another person acting as broker, or to make use of the facilities of an exchange for transactions thereon without payment of a commission or fee or with the payment of a commission or fee which is less than that charged the general public ... ." Id. § 3(a)(3), 15 U.S.C. § 78c(a)(3) (1970). A member
The National Association of Securities Dealers ("NASD") is an organization which regulates the over-the-counter market, that is, the market consisting of transactions effected "otherwise than upon a national securities exchange." In the over-the-counter market, sales are made at a negotiated price by dealers acting as principals who buy and sell either to other dealers or to individual investors at an undisclosed profit. Quotations in the over-the-counter market are not published on a ticker and publicly recorded, but are circulated by the National Quotation Bureau, Inc., a private corporation. To participate in the over-the-counter market, one does not buy a seat, but simply registers with the Commission and the NASD, which in turn is registered with the Commission. In the case of either the stock exchanges or the over-the-counter market, there is also state regulation of many aspects of the securities business. Together, these markets contribute a huge volume to the public capital formation market.

The Securities and Exchange Commission was created by the Exchange Act and was designed to regulate the total spectrum of the securities industry. It is composed of a five member board plus a nationwide staff that enters all phases of the securities business: investigation, enforcement, study, and the proposal of legislation. The Commission has wide powers and a national impact. This article will be concerned with but one aspect of Commission jurisdiction.

Under the Exchange Act, the Commission shares regulatory power over the securities markets with the exchanges and the NASD. It was the intent of Congress in enacting the Exchange Act to retain for the industry some measure of control over the practices of its members. Confronted with enormous stock exchange power and a basic unwillingness to curb abuse, Congress thus made federal assistance available, "letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'

"includes any firm transacting a business as broker or dealer of which a member is a partner, and any partner of any such firm." Id.


15. 2 Loss 1277.

16. See generally id. at 1277-87.


II. THE EXCHANGE ACT

The Securities Act of 1933\(^\text{19}\) deals primarily with a system of disclosure of the economic components of new issues of securities and provides for their registration with the Commission. The Securities Exchange Act of 1934, on the other hand, focuses on the securities industry and provides for regulation of the exchanges themselves, of other groups in the industry who regulate the purchase and sale of securities, and of brokers and dealers in securities.

The Exchange Act places the regulation of exchanges in a specific shared power scheme. The Act first makes it "unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transaction\(^\text{20}\) unless the exchange is registered with the Commission or is exempted from registration. The Act then provides a careful scheme for the registration of exchanges—the source of their regulatory powers. Registration is accomplished by the filing of a registration statement with the Commission. If certain criteria are complied with, the Commission causes the exchange to be registered with it.\(^\text{21}\) Thereafter, the Commission may not suspend or withdraw the registration of the exchange except for cause.\(^\text{22}\)

The Commission prescribes the "form" of the registration statement. Each statement must contain certain agreements, set forth certain information and be accompanied by specified documents.\(^\text{23}\) In its registration statement an exchange must commit itself to aid in the enforcement of the Exchange Act. The exchange must agree "to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of [the Exchange Act], and any amendment thereto and any rule or regulation made or to be made thereunder."\(^\text{24}\) This provision sets up a contractual basis for compliance with the whole range of Commission regulatory directives. Secondly, the exchange must provide the Commission with information on the basis of which it can form a judgment as to the exchange's capacity to regulate its members and customers. Thus,

\(^{20}\) Exchange Act § 5, 15 U.S.C. § 78e (1970). Exemption occurs after exchange application because "in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration." Id.
\(^{23}\) Id. § 6(a), 15 U.S.C. § 78f(a) (1970).
the exchange must provide the Commission with "[s]uch data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors."

Thirdly, the exchange must furnish the Commission with its rules, which constitute a second set of regulatory guidelines alongside those of the Commission itself. These rules include the exchange's constitution, articles of incorporation, by-laws, and other "instruments corresponding thereto." The exchange must also agree to furnish the Commission with amendments to these categories of rules. The rules of the exchange must "include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade . . ." and must "declare that the willful violation of any provisions of [the Exchange Act] or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade." In addition to setting forth the core of the exchange's disciplinary scheme, these provisions raise the distinct possibility of discipline for conduct proscribed and policed concurrently by the Commission and by the exchange itself. This duality is vouchsafed by the Exchange Act which explicitly permits the exchange to enact rules supplementing anything the Exchange Act, the Commission, or state law might address.

A further provision of the Exchange Act presents a minimum standard against which all rules of an exchange are to be measured, and makes it clear that an exchange is by both organization and rule to be a partner with the Commission in the regulatory undertaking. According to that provision: "If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with [the Act] . . . and that [its rules] are just and adequate to insure fair dealing and to protect investors . . ." it shall be registered.

The manner of enforcing exchange rules, after the initial registration, is our primary concern. The Exchange Act allows the withdrawal of reg-

27. Id.
30. The Exchange Act states that "Nothing . . . shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent . . ." with the statute and the rules and regulations under it and applicable State law. Id. § 6(c), 15 U.S.C. § 78f(c) (1970).
32. Id.
istration by the Commission "upon such terms as the Commission may
deem necessary for the protection of investors." There is also provision
for the Commission to cause suspension for up to one year or withdrawal
of registration if the Commission finds that the exchange "has violated
any provision of [the statute] or of the rules and regulations thereunder
or has failed to enforce, so far as is within its power, compliance there-
with by a member or by an issuer of a security registered thereon.
Of course, this is a very drastic remedy, since even an hour's suspension
during trading hours would be severe punishment that could disrupt op-
erations and trading in stock, presumably across the board. There are
some mediate remedies whereby the Commission itself may step in and
take punitive action either against a security, by suspending its registra-
tion, or suspending trading in it; or against a member or officer of a
national securities exchange, by suspending his license for up to one year
or using the power to "expel" him from the exchange. This may occur if
the member or officer has violated the statute or the rules and regulations
thereunder—which may arguably include all or some exchange rules—or
if he "has effected any transaction for any other person who, he has
reason to believe, is violating in respect of such transaction [the Exchange
Act] or the rules and regulations thereunder." This provision encour-
ages exchange prosecution of offenses by individual members and officers.
Another remedy available to the Commission is the right to request an
exchange to "effect on its own behalf specified changes in its rules and
practices . . . ." Such changes, it may be presumed, may be prompted
by, but not usually directed against, specific abuses by particular persons.

Some idea of the type of situation which is of statutory concern to the
Commission is rendered by the concomitant provision which allows the
Commission "by rules or regulations or by order to alter or supplement
the rules of such exchange (insofar as necessary or appropriate to effect
such changes) . . . ." Once again, this is not directed towards specific
instances of abuse, but, in keeping with the tenor of the Exchange Act,
allows the Commission to oversee the general substance of exchange rules.
We arrive at this judgment by noting that the Commission's power to
discipline members and officers of exchanges is confined to situations of
violations of the Exchange Act itself or "the rules or regulations there-

37. See note 45 infra and accompanying text.
40. Id.
under," reading "thereunder" as not including all exchange rules so that the jurisdiction of the Commission is concurrent with that of the exchange itself.41

The Commission is authorized to order changes which are "necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange . . . ."42 The list of matters which may be altered or supplemented amounts to a catalogue of the areas of exchange regulatory responsibility and concern.43

III. DISCIPLINARY PROCEEDINGS UNDER THE EXCHANGE ACT

Under the Exchange Act, as we have seen, there is no express grant of authority to the Commission to require the stock exchanges to discipline their members or for Commission review of exchange disciplinary proceedings. The Act simply provides for registration by the filing of a registration statement which includes an agreement to comply with, and to enforce compliance by its members with, the provisions of the Exchange Act and "any rule or regulation made or to be made thereunder."44 It has been held, in the context of civil suits by private persons against other private parties for violation of exchange rules, that such rules are not to be deemed rules "thereunder."45 It is thus arguable that the Exchange Act is speaking here only of rules promulgated by the Commission itself and not of those exchange rules which are not expressly commanded by the statute.

In either event, the manner by which an exchange is to enforce compliance, which is left open by the Exchange Act, is presumably by discipline

43. The list includes: (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or removal from listing of any security; (4) hours of trading; (5) the manner, method and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters. Id.
of its members. There is a specific statutory requirement that exchange rules include provision for the expulsion, suspension or disciplining of members for conduct inconsistent with just and equitable principles of trade.\textsuperscript{46} According to the statute, such conduct specifically includes willful violations of the statute and any rule or regulation thereunder. It is the statute's omission of other categories of exchange rules that suggests that such other rules are not within the agreement to enforce compliance. However, even with respect to rules proscribing conduct inconsistent with just and equitable principles of trade, the statute does not say that the Commission may either review expulsion, suspension or disciplinary proceedings or compel their institution. The statute merely grants the Commission power to suspend or withdraw an exchange's registration should it fail to enforce compliance with the statute or the rules and regulations thereunder,\textsuperscript{47} or fail to alter or supplement certain categories of exchange rules or practices.\textsuperscript{48}

Short of suspension or withdrawal of registration, the statute merely requires that a registering exchange agree to include rules which are "just and adequate to insure fair dealing and to protect investors"\textsuperscript{49} and which include penalties for "conduct or proceeding inconsistent with just and equitable principles of trade."\textsuperscript{50} If either category is covered by the Act, whether or not intended by its framers, compliance by members must be enforced by the exchange under its agreement to do so. The statute does not give the Commission the express right to seek specific performance of the agreement or to sue for damages for breach. Presumably, however, breach of the agreement in the sense of failing to enforce compliance with the statute and the rules and regulations thereunder triggers the suspension-or-withdrawal-of-registration mechanism.

Many matters, in addition to the mediate remedies available to the Commission and its power to review or compel the initiation of disciplinary proceedings, are unmentioned in the statute. Although the Commission itself may step in against a member or officer of an exchange who has violated the Exchange Act or the rules or regulations thereunder,\textsuperscript{51} it is not clear if it may do so where an exchange rule other than one dealing with conduct inconsistent with just and equitable principles of trade is concerned. Aside from the listed areas where rules may be supplemented, there is very little specification of what the exchange rules are to contain. This may in part be a gesture of respect for exchange

\textsuperscript{49} Id. § 6(d), 15 U.S.C. § 78f(d) (1970).
\textsuperscript{50} Id. § 6(b), 15 U.S.C. § 78f(b) (1970).
expertise and self-determination. However, there is a similar silence as to the mechanics of disciplinary procedure—in marked contrast to the explicitness of the Exchange Act's provisions governing national securities associations where "appropriately disciplined" expressly includes "expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty. . . ."53 The statute also provides for Commission review of certain disciplinary proceedings of these associations.54 Thus, the statute's silence when addressing itself to the stock exchanges on this issue may be interpreted as a Congressional desire to exclude such provision in this context. While not a necessary conclusion, the familiar maxim expressio unius est exclusio alterius is persuasive here.55

In speaking of this power of review there is further ambiguity. For one thing, review in the broadest sense may be guaranteed by the withdrawal or suspension power. In granting this power, the statute does not speak of exchange rules with respect to "conduct or proceeding inconsistent with just and equitable principles of trade" or of rules whose purpose it is to insure fair dealing and protect investors, although it is hard to imagine how any rule could not be included within these two categories. In fact, where such rules are dealt with, the Act speaks only of their existence and not of their enforcement. It is thus possible that there can be no suspension or withdrawal with respect to violation of rules within these categories.

Nevertheless, it is a primary canon of statutory construction to interpret a statute so as to give effect to all the words and provisions therein.57 It is arguable, therefore, that exchanges would not have been required to provide for disciplining for "conduct inconsistent with just and equitable principles of trade" or to insure fair dealing and to protect investors without the expectation that the provision would be utilized. The express, alternative remedies available under the statute would obtain only if an

52. See id. § 15A, 15 U.S.C. § 78o-3 (1970). Such applications primarily include the NASD.
exchange rule with respect to the matter would be considered a rule under the Act and thus a basis for a Commission proceeding against the member himself. Such action would place the Commission in the anomalous and historically untenable position of itself enforcing the rules of a self-regulatory body. Another alternative is to consider the rule as one under the Exchange Act and therefore a basis for the inappropriately severe remedy of suspension or withdrawal of registration. Deregistration is so drastic a remedy that it may be said to imply power in the Commission to impose a lesser penalty when it acts on a single instance or something less than a pattern of exchange non-enforcement. If so, a remedy consonant with shared regulatory power and proportionate to the single instance of abuse is the implied right to require that the exchange institute a disciplinary proceeding. Presumably, this remedy would be enforceable at the hands of the Commission by the threat of suspension or withdrawal of registration, or by court order.

Because of the existence of Commission self-help under the Exchange Act, the inference that the Commission can require an exchange to institute disciplinary proceedings is less easily drawn where the single or infrequent violations are of rules and regulations under the Act. But in the instance of "conduct inconsistent with just and equitable principles of trade" and perhaps with rules which insure fair dealing and protect investors, the obligation to discipline must be enforceable. Moreover, if the violated rules were rules under the Act, the exchange's agreement to enforce such rules would also be enforceable by an action or proceeding on the contract, such as an action for specific performance. It would be pointless to have an agreement with which an exchange could not be made to comply. One court, discussing this issue, has recognized that the enforceability of the agreement should be left up to the discretion of the Commission.58

IV. ENFORCING EXCHANGE RULES BY PRIVATE ACTION

No instance has been found in case law of an exercise of Commission power to compel an exchange to discipline one of its members or officers, or of direct Commission review of such a disciplinary proceeding. Instead, there are a series of cases dealing with individual action against an exchange or against a particular exchange member.59


individual litigant is quite different from that of the Commission, for an individual's interest is ordinarily personal, whereas the Commission is likely to think in terms of a broad class such as the general investing public, when initiating an action. Individuals may also have less investigative power to search out and identify instances of member abuse; the Commission, because of its surveillance of the securities industry, is in a better position to do so. Moreover, because of its continuing relationship with the exchange and its deregistration power, the Commission may be in a superior bargaining position with the exchange to bring about corrective action. Surely its panoply of remedies is imposing, even though it cannot garner money damages—the basis for private action.

The reported cases present very few instances of actions against exchanges by private litigants. Most involve actions against persons who have violated exchange rules, rather than derivative proceedings against the exchanges themselves. These cases rest on an implication of civil liability in the Exchange Act derived from its provision that district courts shall have exclusive jurisdiction over violations of the Act or the rules and regulations thereunder and of all suits in equity and actions at law brought to enforce any liability or duty created by the Act or the rules and regulations thereunder. The implication rests on the familiar


62. Exchange Act § 27, 15 U.S.C. § 78aa (1970). The two reported state court cases under section 6 of the Exchange Act have taken divided views on whether there was state court jurisdiction despite section 27. In Rospigliosi v. Clogher, 46 So. 2d 170 (Fla.), cert. denied, 340 U.S. 853 (1950), the Florida Supreme Court did not appear to be bothered by section 27 and considered the question of whether there was a cause of action under an exchange rule that an employee must not have an interest in a customer's account. In rejecting the claim, it held that not every rule which an "exchange considers necessary to insure fair dealing automatically becomes a rule under the statute, the violation of which would amount to a transgression of that law." 46 So. 2d at 172. It is not clear whether the court felt it was considering a state cause of action, although we probably must assume that. Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949), had raised the question whether the cause of action sprung from a common law tort which merely took as its standard the 1934 Act. It has been held that the fact of passage of a statute does not defeat a
principle that breach of a statutory duty normally gives rise to a private action on behalf of the injured person for whose benefit the statute was created. The argument that a stock exchange rule is one under the Act was not uniformly accepted in these cases, but where liability was enforced, such a reading of the Act was acknowledged. On this basis, it may be argued, therefore, that such a Commission right obtains under the Act.

V. PRIVATE ACTIONS AGAINST EXCHANGES

A second group of cases is even more directly relevant to the question of Commission power. These cases concern private actions against exchanges themselves, and in some instances present the direct question whether an exchange has failed to enforce compliance by its members with rules of the exchange. In the leading case of *Baird v. Franklin*, a private citizen brought an action against the New York Stock Exchange for damages occasioned by the Exchange's failure to take disciplinary action against a member after there was reason to believe that the member had converted the plaintiffs' securities. The Second Circuit broadly conceded that the statutory scheme of the Exchange Act placed upon the Exchange a duty to enforce its rules against member abuse. The majority opinion stated that the terms of the duty were to "investigate the dealings and the financial conditions of the members and to suspend or expel members who it had reason to believe had been guilty of conduct inconsistent with just and equitable principles of trade." The duty to suspend or expel was thus grounded upon "reason to believe" rather than upon proof by a preponderance of the evidence or proof beyond a reasonable doubt. The majority in *Baird* based its finding of an exchange duty

common law remedy in the United States. United States v. Silliman, 167 F.2d 607 (3d Cir.), cert. denied, 335 U.S. 825 (1948). Most recently in New York Stock Exch. v. Pickard & Co., 282 A.2d 651 (Del. Ch. 1971), the court declined to take jurisdiction of a counterclaim whose gravamen was the allegation that the stock exchange, which had sought recovery of funds advanced to pay customers of a brokerage house, had failed to enforce compliance by the brokerage house with the 1934 Act. *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964), earlier had raised, but did not decide, whether a violation of a stock exchange rule gave rise to a cause of action under state law. See Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961).

65. See cases cited note 60 supra.
66. 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).
67. "We accede to the view that the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937, after there was reason to believe that the latter had converted the plaintiffs' securities," 141 F.2d at 239.
68. Id.
69. The alternative of discipline, announced in the statute was curiously absent from the court's pronouncement.
upon the Exchange Act provision requiring rules for "expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade."\(^{70}\) The duty to have rules is a duty to enforce such rules. This, in turn, is the basis of an enforcement right in the Commission. While this statement of the duty was implicit in the majority opinion, the dissent expressly stated that the Exchange Act "places a duty upon the Stock Exchange to enforce the rules and regulations" which, by reason of the registration, had been accepted as "just and adequate to insure fair dealing and to protect investors." Amplifying the majority opinion in this respect, the dissent reasoned that the passage of mere "token regulations" without the concomitant obligation to enforce them would have rendered the statute "meaningless."\(^{71}\) Declining to answer the question of whether or not plaintiffs were third-party beneficiaries of the exchange-Commission agreement, because the answer was not necessary to its conclusion,\(^{72}\) the dissent found the right of action in the Act. It parted company from the majority only in finding that the Exchange had proximately caused damage to the plaintiffs.

_Baird_ has been followed in several cases and extended to include negligent violations of the statute.\(^{73}\) However, the natural progression which would have made the Commission the watchdog of the exchange's duty to enforce Exchange rules has apparently not transpired. As far back as 1941, the Commission had called to Congress' attention the absence in


\(^{71}\) 141 F.2d at 244. "There can be no doubt that § 6(b) places a duty upon the Stock Exchange to enforce the rules and regulations prescribed by that section. Any other construction would render the provision meaningless. Defendant's argument that the Securities Exchange Act did not alter the prior status of the Stock Exchange Rules as by-laws of a private club is untenable. If all that § 6(b) meant was that every exchange should pass token regulations, incapable of enforcement except at the wish of the exchange itself, there would have been no purpose for its inclusion in the Act. Sections 6(b) and (d) were surely intended to be read together, and the latter makes it clear that the purpose of the requirements of the former is 'to insure fair dealings and to protect investors.' This can be realized only if § 6(b) is construed as imposing the twofold duty upon an exchange of enacting certain rules and regulations and of seeing that they are enforced.

"The Stock Exchange, therefore, was under a duty on November 24, 1937, to take disciplinary action against Richard Whitney for the various violations of the Securities Exchange Act and the Rules of the Exchange which it either knew of or at least had reasonable cause to suspect. Its complete inaction for some two months was a dereliction of that duty and a violation of § 6(b) of the Act." Id. (dissenting opinion). This passage in the dissent was considered a reflection of the opinion of the entire court. Silver v. New York Stock Exch., 302 F.2d 714, 719 (2d Cir. 1962), rev'd on other grounds, 373 U.S. 341 (1963).

\(^{72}\) 141 F.2d at 244.

the statute of an express or clear right to compel an exchange to enforce its rules. Yet, rather than seek this remedy, the Commission sought instead to have its own jurisdiction include enforcement of non-Commission exchange rules, and to have it made clear that it might suspend or revoke an exchange's registration for failure to enforce compliance with the exchange's rules. Perhaps the Commission felt that such a remedy would bear down too drastically on its self-regulatory partner. Nevertheless, in light of its legislative strivings, it cannot be said that the Commission considered its inability to force compliance with non-Commission exchange rules an insignificant matter.

The exercise of Commission jurisdiction to enforce exchange rules has not been criticized by textwriters, who have either ignored the question or have appeared to agree with the latitude suggested by Baird. The major challenge to such jurisdiction has instead come from some rather broad language in the United States Supreme Court's opinion in Silver v. New York Stock Exchange. Silver was a civil action by a non-member broker-dealer against the New York Stock Exchange for, inter alia, violation of the antitrust laws through enforcement of its constitution and rules by coercing members to discontinue providing customers with private wire connections to their offices. In reaching the conclusion that the Exchange had violated the antitrust laws, the Court was persuaded in part by the absence of Commission jurisdiction to review the Exchange's action. But the use of the word "jurisdiction" may have suggested that initiation as well as review of "specific instances of abuse" was being discussed. In any event, careful reading of the Silver decision compels a contrary conclusion. Echoing the textwriters, the Court found review power to be lacking. It left standing the Second Circuit dictum that the Act "makes it a duty to enforce the rules which it is required to file with the Commission."

74. 2 Loss 1176.
75. Id.
77. See 2 Loss 1177-78.
79. "Although the Act gives to the Securities and Exchange Commission the power to request exchanges to make changes in their rules . . . it does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules . . . . This aspect of the statute, for one thing, obviates any need to consider whether petitioners were required to resort to the Commission for relief before coming into court." Id. at 357-58.
80. 373 U.S. at 358.
Notwithstanding this reading of Silver, at least one court has left the status of Baird v. Franklin in some doubt by reading the Silver dictum with respect to curbing "specific instances of abuse" to mean that the Commission could not initiate a proceeding of some unnamed sort against an exchange for the exchange's failure to comply with provisions of its constitution.\textsuperscript{82} Despite this broad language, Bright v. Philadelphia-Baltimore-Washington Stock Exchange\textsuperscript{83} appears to have addressed itself to a situation where the exchange had violated its own constitutional provisions, rather than where it had failed to enforce its provisions against a member.

VI. The Means of Enforcing Exchange Rules

Other alternatives are available to enforce exchange rules. In the first place, the exchange might be left free to enforce its own rules without Commission or judicial oversight. Certainly its expertise would make it uniquely capable of identifying and punishing abuse. The exchange would have a special feel for the issues involved and the magnitude of the abuse against the pattern of dealing of the defendant in question. It could attune its remedy to its sense of the marketplace without the possibility of Commission or judicial intrusion. The exchange could conserve its position as a self-regulatory partner of the Commission by keeping


\textsuperscript{83} The Bright court wrote: "Finally, defendants argue that the Commission does not have the power to curb specific instances of abuse with regard to the rules of the exchange, and, therefore, it follows that the Courts also do not have such power. Section 27, however, provides that District Courts shall have exclusive jurisdiction of violations of any duty created by the Act. It does not provide that jurisdiction is limited to those violations over which the Commission has concurrent jurisdiction and cannot be so read. Jurisdiction of the Commission or lack thereof has no bearing whatsoever upon jurisdiction of this Court pursuant to Section 27.

"Thus, it is immaterial for purposes of jurisdiction under Section 27 of the Act whether or not the Commission has the power to curb specific instances of violations of a duty created by Section 6. Defendants, however, contend that the Commission does have such power and, therefore, plaintiff has failed to exhaust his administrative remedies because he never sought relief from the Commission.

"Section 19 of the Act, 15 U.S.C. § 78s, defines the powers of the Commission with respect to exchanges. The Commission is authorized to suspend or withdraw the registration of a national securities exchange if it finds that the exchange has violated any provision of the Act or failed to enforce compliance therewith by its members. Suspension or withdrawal of registration is a drastic remedy available only in flagrant cases, and obviously is not an appropriate remedy for plaintiff. Surely, it was not intended that the Act would authorize the Commission to take such extraordinary action in a situation like that of plaintiff. The Act did not give the Commission the power to curb specific instances of abuse. . . . Thus, plaintiff shall not fail because he did not seek redress of his grievances from the Commission." 327 F. Supp. at 502-03.
for itself the enforcement of rules whose adequacy the Commission had already passed upon. On the other hand, the abuses inherent in this private-club thinking have by now been exposed. The tendency to deal too favorably with those inside the “club” and to give short shrift to investors is probably too pronounced to allow the exchanges to be their own final arbiters. In addition, the public is by now too accustomed to the protection of its rights to allow exchanges to sweep abuses under oriental carpets.

As a third-party beneficiary of the Commission-exchange relationship, the investor may rest in a more comfortable position. He might be required first to exhaust his administrative remedies by seeking Commission participation in curbing a specific abuse and availing himself of Commission fact-finding and enforcement powers. Under such a theory, the investor would presumably be able to resort to judicial remedy should the Commission decline to act in a particular instance of abuse. He would not be left to make his own case on deposition against hostile parties and the role of shared Commission-exchange power would be preserved.

Conversely, as a third-party beneficiary of the investor-exchange relationship, the Commission would have the power to group cases of individual abuse into a class action. Individuals would benefit from a consolidated litigation by avoiding the difficulty and expense of separate suits. The Commission could make use of its superior fact-finding and adjudicative design and the exchange would look to the Commission as a forceful body to whom it would be accountable.

Were the Commission to inspire disciplinary action itself by informal suggestion to an exchange while holding mandamus power in reserve, presumably exchanges would be unlikely to make self-serving decisions. While the exchange would maintain its own procedures in the actual disciplinary hearing, the Commission could step in where it appeared that exchanges had overlooked the abuse or failed to take appropriate action. As in any prosecutorial action, much of the repudiation and punishment is achieved by the identification of an abuse and the initiation of a proceeding, whatever may be its ultimate result. It has been noted by at least one court that enforcing compliance with the Exchange Act and Commission rules and regulations so far as is within the power of an exchange does not exact an undue burden.\(^8\) The exchange need not “investigate and pry into every phase of its members’ activities, but on the other hand it cannot simply sit back and take no affirmative action whatsoever in enforcing compliance with the Act.”\(^9\)


formulation, it at least underlines the point that courts will not force intolerable duties on the exchanges.

If initiation by identification were to begin with the Commission, it would likely inform the exchange of the abuse and recommend or require action. Alternatively, the Commission might, by formal action, require discipline by the exchange, enforcing its demand either by threat of invocation of one of its statutory remedies or, more likely, the threat of seeking mandamus or like judicial remedy. Such a judicial remedy presumably would be available at an initial stage or as an alternative to an administrative ruling. Conceivably there could also be a requirement to invoke a proceeding for violation of a Commission rule where the rule covered the abuse in question. The alternative of engaging, threatening or encouraging a private party to sue for violation of an exchange rule would seem a severe restraint upon individual action, especially where threats were employed.

Another significant consideration is whether or not the Commission has disciplined a member. If it has acted within its powers, it is arguable that the idea of shared responsibility makes it less important that an exchange be compelled to initiate proceedings. On the other hand, it is arguable as well that where the exchange and the Commission might reach contrary results, the exchange should not be left free to support or countenance an opposing result, thus giving the appearance of a less than united front between the two agencies. Therefore, where exchange action is a needed supplement to Commission action or where exchange expertise and familiarity with the factual situation make it more likely that the exchange would reach the desired result, it might be helpful to “imply” Commission power under the statute to compel the exchange to invoke its disciplinary powers. Such an implication might be more difficult if the violation is of a Commission statute, rule or regulation. Distinctions in this regard might also be relevant where the exchange rules are more in the nature of housekeeping. Double jeopardy would presumably be avoided since there would be no need to discipline twice under the Act. However, in any case the decision as to who was to seek enforcement first, or who was more aptly the disciplinarian, would best be decided on the basis of suitability where, hopefully, a certain cooperative zeal would be evident.

Were the Commission merely to review exchange disciplinary action without compelling its initiation, the exchange would have the advantage of being left free to identify and judge abuse by its own procedure. This method, however, would give the Commission an opportunity to enter the picture only where an exchange proceeding had been undertaken. It could thus leave many violations unpunished. While the Commission is well suited to hear such cases on review, and the public interest would thus
be carefully looked after, without initiatory power, the mechanism would have severe shortcomings.

VII. THE REPORT AND RECOMMENDATIONS OF THE SECURITIES AND EXCHANGE COMMISSION

The above factors were certainly considered by the Commission in its report and recommendations entitled, *Study of Unsafe and Unsound Practices of Brokers and Dealers* ("Report"). It is not the object here to examine the Report in detail, but merely to focus upon those of its recommendations which concern disciplinary proceedings.

The basic finding of the Report was that recent back-office and related securities market difficulties indicate that "present authority is insufficient to insure fair and effective self-regulation in the areas of rule-making, enforcement and disciplinary proceedings." For whatever reason, it is clear that exchange rules have not been effectively enforced. Of paramount importance is the Commission's lack of power to enforce directly the rules of the self-regulatory organizations against their members. This was apparently the thrust of *Bright v. Philadelphia-Baltimore-Washington Stock Exchange*.

Sensing a crisis in the industry—as from increased customer complaints—the Commission might nonetheless be incapable of doing anything to ameliorate individual instances of abuse. The remedy proposed herein is one avenue of redressing the situation. Legislation of the nature recommended in the Report would grant the Commission authority to directly enforce the rules of the self-regulatory organizations, presumably after exchanges had been told what the Commission considered necessary and had either failed to take action or would not have time effectively to do so.

Of broader moment is the Report's recommendation that the Commission be granted the authority to review all disciplinary actions taken by self-regulatory organizations. Review would be on appeal by any affected party or on the Commission's own motion. Review authority would include the power to affirm, dismiss or modify any penalties in any manner the Commission deemed necessary "in the public interest" and "to insure the fair administration of discipline by the self-regulatory organization." The caveat would be imposed on the review authority, as well as on the Commission enforcement proposal, that while the Commission's authority over the self-regulatory organizations would be increased, "these powers would be exercised only infrequently." Thus, the effect would be to

86. H.R. Doc. No. 231, 92d Cong., 1st Sess. (1971); see note 1 supra.
88. 327 F. Supp. 495 (E.D. Pa. 1971); see note 83 supra.
90. Id.
91. Id.
provide additional weapons for times of crisis or grave injustice; not to
distort the balance between Commission and exchange regulatory power. 
Taken at face value, the extreme degree of exchange power and jealousy 
for its prerogatives as well as the limitations on Commission personnel 
expansion would probably not permit the Commission to take over the 
whole disciplinary process.

According to Silver v. New York Stock Exchange92 and the textwriters 
cited therein,93 express legislative authority appears to be required for 
the Commission to entertain disciplinary proceedings on review. The 
express authority given the Commission to review NASD disciplinary 
actions makes the failure to provide for exchange disciplinary proceed-
ings an expression of intent that the Commission should not have such 
power. Nevertheless, the Commission is carefully designed to undertake 
such review and to pay heed to larger public interest objectives in reaching 
its decision. It is likely to give such disciplinary proceedings a broader 
scope of review than the traditionally limited review given by courts to 
such private rules, cloaked as they may be with the public interest.

Because of the public registration of exchanges as well as federal 
scrutiny, issues of due process in such hearings are bound to surface. Silver 
itself held that such constitutional requirements must be respected 
by exchanges in enforcing their constitutions and rules.94 There is already 
a strong body of procedural safeguards pressed on the Commission in 
its hearing procedures,95 and the visibility of Commission actions, coupled 
with ready court review, would make Commission review of exchange 
disciplinary proceedings a welcomed innovation. While the Report fails 
to specify whether review would be de novo or whether findings of fact 
by an exchange would be accepted on review, except perhaps, where 
clearly erroneous, Congress might well make such a specification. The 
"clearly erroneous test" or a test of "substantial evidence on the record" 
might, if enacted or judicially applied, leave exchange expertise intact and 
render tolerable the burden of the Commission on review.

Nevertheless, it is unfortunate that the Report did not deal with the 
Commission's power to require the exchanges to discipline their members. 
Perhaps, it did not wish to prejudge a position that the Commission hopes 
to assert judicially. Hopefully, the Report and its legislative progeny will 
not be considered as a waiver of the judicial implication in the Exchange 
Act as presently enacted. Surely this mediate remedy would be more 
attuned to shared regulatory responsibility and might rest easier with 
the exchanges themselves.

93. Id. at 357-58. 
94. Id. at 361-66. 