UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 30501

NORMAN L. HARWELL, et al.,

Plaintiffs-Appellants,

v.

GROWTH PROGRAMS, INC., et al.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Western District of Texas

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION, AMICUS CURIAE

COUNTERSTATEMENT OF THE ISSUES PRESENTED

The National Association of Securities Dealers, Inc. ("NASD"), a self-regulatory association subject to the oversight of the Securities and Exchange Commission pursuant to Section 15A of the Exchange Act of 1934, issued an interpretation of one of its Rules of Fair Practice, a rule requiring NASD members, in the conduct of their business, to ". . . observe high standards of commercial honor and just and equitable principles of trade." The interpretation deemed it inconsistent with

that rule for a member to use or permit the use of a so-called "withdrawal-and-reinstatement" privilege in programs to acquire mutual funds in a manner detrimental to the interests of shareholders in the mutual funds involved and set forth guidelines as to the appropriate use of that privilege. Did the district court properly determine:

(1) That this interpretation was valid, where the Commission and the NASD had found that speculative use of the withdrawal-and-reinstatement privilege in recent years by certain investors had caused harm to shareholders in mutual funds affected and to the funds themselves?

(2) That there had been no denial of due process in the issuance of this interpretation, where the NASD by-laws expressly authorizes its Board of Governors to make and issue interpretations of NASD Rules of Fair Practice, where the members of the Board of Governors fairly represent all segments of the investment banking and securities business and the Commission is vested by statute with power to disapprove proposed NASD rules or rule amendments and to abrogate, alter or supplement existing NASD rules?

(3) That the interpretation was properly applied with respect to persons whose contractual rights to the continued use of the withdrawal-and-reinstatement privilege was not specifically limited by contract?

(4) That the issuance of the interpretation did not violate the antitrust laws?

COUNTERSTATEMENT OF THE CASE

This is an appeal from an order of the District Court for the Western District of Texas filed on June 8, 1970, granting defendants-appellees' motions for summary judgment (A 794).[1/] The Securities and Exchange Commission respectfully submits this brief, amicus curiae, on the issues of law involved in this appeal, which pertain largely to Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3, *et seq.*, hereinafter referred to as the Maloney Act.[2/]

The plaintiffs-appellants, owners of contracts in Growth Programs, Inc. totalling $826,000, brought this action on behalf of a class of 1,258 purchasers of single-payment contractual plans issued by Growth Programs, Inc. for the purchase of shares of Technology Fund, Inc. (the "Fund").[3/] (A 551; Br 2.) The amended complaint names as defendants Growth Programs, Inc., the sponsor and sales agent of the Fund's single payment contractual plan; Supervised Investors Services, Inc., the Fund's principal underwriter and management company; and the National Association of Securities Dealers, Inc. (the "NASD"), a voluntary association of securities

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1/ "A" refers to pages of the Appendix filed by the appellants with this Court. "Br" refers to pages of appellants' opening brief. "Px" refers to exhibits introduced by plaintiffs-appellants in the district court.

2/ The Maloney Act, adopted in 1938, amended several provisions of the Securities Exchange Act of 1934 and added Section 15A to that Act.

3/ This open-end investment company was formerly called Television Electronics Fund, Inc. Open-end investment companies are sometimes referred to herein as "mutual funds" or "funds."

The plaintiffs in this lawsuit were originally limited to residents of San Antonio, Texas; on December 8, 1967, by permission of the court, the scope of the lawsuit was expanded to "all other program-holders holding single investment program contracts with Defendant Program Company . . ." (A 468, 523).

dealers and the only "national securities association" registered with the Commission under Section 15A of the Securities Exchange Act (A 542).[4/] This class action, instituted on September 16, 1966, was based on alleged breaches of contract and violations of the federal antitrust laws, and sought damages,[5/] a declaratory judgment, specific performance and injunctive relief to compel the resumption of certain contractual obligations by the defendants-appellees.

All the investment contracts held by members of the class contained a withdrawal-and-reinstatement privilege referred to in sales brochures of Growth Programs as the "in-and-out" privilege (A 776; Ratzlaff's Deposition, Ex. 1, p. 2), whereby the investor had the right to liquidate, from time to time and at any time,up to ninety percent of the then market value of his shares in the Fund and thereafter at any time, to reinvest the same amount

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4/ Two other defendants, the Fund and First National Bank of Jersey City, were dropped by stipulation (A 397-402).

5/ The amended complaint sought actual and exemplary damages from defendant NASD for its alleged unlawful interference with the performance of the contracts and treble damages from all the defendants for an alleged conspiracy in violation of the antitrust laws (A 568-569). In the brief filed with this court, the plaintiffs-appellants state that since the contracts here involved had a term of 30 years, "it is virtually impossible to anticipate, much less calculate, the damages" that would result from a continued breach of said contracts and therefore the only adequate remedy would be specific performance and issuance of an injunction (Br 12-13). However, in connection with their antitrust arguments, appellants urge, among other things, that the case be reversed and remanded to the district court "for trial of the damage issues . . ." (Br 53).

of cash in shares of the Fund at the then net asset value of those shares, all without payment of any further sales charge.[6/] The district court found: "Although the Growth Programs Prospectus contained a statement that 'this is

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6/ The pertinent portion of the Fund's Prospectus, dated April 30, 1965, stated:

> "(3) Partial Withdrawal Without Termination:
>
> "At any time after purchasing a Single Investment Program, the Programholder may, without terminating his Program, withdraw part of his Fund Shares or direct the Custodian to liquidate part of his Fund Shares and remit the net proceeds, provided that the Shares involved in such withdrawal or liquidation have a net asset value of at least $50 and do not constitute more than 90% of the Fund Shares in his account. Where a partial liquidation has been effected, the Programholder may at any time restore in cash up to the same dollar amount so received by him and have it applied to the purchase of Fund Shares at their then net asset value" (Chorn Deposition, Px 78A, p. 4).

Each plaintiff's contract contained the following provisions:

> "(e) Partial Withdrawal Without Termination:
>
> "At any time after the issuance of this Program, the Programholder may without terminating this Program, withdraw part of his Fund Shares, provided such withdrawal shall involve not less than $50.00 of liquidating value and not more than 90% of the Fund Shares standing to his account.
>
> * * *
>
> "If the Programholder has made a partial withdrawal and caused Fund Shares to be liquidated and the proceeds remitted to him, he may at any time thereafter pay to the Custodian, in cash, up to the same dollar amount received by him in connection with such partial withdrawal and liquidation and have the same applied to the purchase of Fund Shares at their then net asset value. If the Programholder has made a partial withdrawal and received certificates for Fund Shares, he may, at any time thereafter, restore in kind up to the same number of Fund Shares so withdrawn" (A 24).

a long term investment program, not designed for a quick profit,'" the unlimited use of the withdrawal-and-reinstatement privilege was given "prominent play" in sales brochures (A 776). The appellants contended that the unlimited use of this privilege which was emphasized in the promotional literature and prospectuses of Growth Programs "constituted a major consideration for the purchase of such plans" (Br 4, 7).

The withdrawal-and-reinstatement privilege, as the NASD has noted, [7/] originated in the 1930's as a means of preserving investments in periodic-payment contractual plans for the accumulation of mutual fund shares when the investor--particularly one of modest means--was faced with a "genuine financial emergency" (A 775); this in-and-out provision was eventually carried over to single payment contractual plans which were set up within the same framework as periodic payment contractual plans. As the district court explained:

> "Before such in-and-out provisions were inserted in investment contracts, modest investors usually could not afford to liquidate and reinvest because 50% of the total brokerage fee on a long term contract was taken out of the first year's investment, and in order to recoup the heavy front-end sales commission, investors had to leave their money in the program uninterrupted for a number of years" (A 775-776).

The court went on to note that, until 1965, the withdrawal-and-reinstatement privilege was exercised sparingly, as contemplated (A 776).

As the court found, however, in 1965 Growth Programs, Inc. and other mutual fund sponsors devised an investment contract which facilitated the

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7/ CCH NASD Manual ¶ 5261 (1970).

use of the withdrawal-and-reinstatement privilege for speculative purposes, "namely to play short swings of the stock market" (A 777). For example, the Growth Programs Prospectus provided that the privilege could be exercised an unlimited number of times; that the investor could give instructions for withdrawal-and-reinstatement by telephone or wire; that such instructions could be given through a securities dealer; and that the price at which such withdrawals (except in the event of a general decline in security prices) and reinstatements were to be effected would be the net asset value of the underlying fund shares at the time the telephone or wire instructions were received (A 24-25, 125-127). The telephone or wire order privileges greatly facilitated the speculative use of the withdrawal-and-reinstatement privilege in that it made the price at which shares could be liquidated or repurchased immediately determinable, which was not possible when only written order instructions were permitted. The NASD described the speculative practices involved:

> "For example if a planholder believes, or his dealer leads him to believe, that the market is due for a downturn, he may withdraw 90 percent of his account in cash. Then if the market goes down, the investor or his dealer will, at a point believed to be the bottom of the downturn, replace the withdrawn cash with the fund underwriter, thus acquiring more shares of the underlying fund than the investor redeemed, and at no sales charge. The planholder can continue this practice as often as he or his dealer thinks the short swings in the market can be predicted." CCH NASD Manual ¶ 5261 (1970).

The court pointed out that by a single call by a broker, acting through a power of attorney executed by programholders, "massive withdrawals and reinvestments were often effected on the same day, taking advantage of fractional swings in the market" (A 777). Further, as the NASD has

noted,[8/] the speculative use of the withdrawal-and-reinstatement privilege was further facilitated when custodian banks evolved a practice whereby they would merely hold checks representing the proceeds from withdrawals, or merely credit the account of the investor with such proceeds, thereby enabling the investor immediately to apply the same funds in repurchasing or reinstating the previously withdrawn shares in his contractual plan account.

The problem was summarized in a report submitted by this Commission to Congress:[9/]

> "In recent years there appears to be a growing use by speculatively oriented investors of withdrawal and reinvestment privileges in connection with single payment plan certificates issued by contractual plan companies . . . . [T]he extensive use of single payment plan withdrawal and reinvestment privileges by a relatively few speculatively minded investors could seriously circumscribe at critical times the exercise of managerial discretion in the interest of the large majority of shareholders who have long-term investment objectives. It creates substantial questions of fairness to the large majority of mutual fund shareholders who make their investments and pay a continuing fee to obtain the unencumbered investment judgments of professional management, not of fellow shareholders interested in speculation. Moreover, it is the entire body of shareholders in a fund, rather than these speculators alone, who bear the increased brokerage costs that are incurred."

In a seven page letter, dated September 21, 1966, addressed to the Board of Governors of the NASD, William G. Chron, on behalf of Growth Programs,

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8/ CCH NASD Manual ¶ 5261 (1970).

9/ Report of the Securities and Exchange Commission on Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 304-305 (1966).

Inc., the Fund's sponsor and sales agent, stated:

> "Possibly because of wide and frequent fluctuations in the market during the latter part of 1965, the frequency of the use of the partial withdrawal privilege increased substantially, to the extent that it did cause an administrative burden upon the Sponsor and the Custodian Bank" (Ratzlaff's Deposition, Px 8, pp. 3-4).

Mr. Chorn cited the aggregate amount of "in-and-out trading" in the Fund's shares under the withdrawal-and-reinstatement privilege to approximate $20,000,000 for the six-month period from August 1965 to January 1966 (id. at 3). The increase in use of the privilege in the early months of 1966 was extreme: the Fund's semi-annual report for the six months ended April 30, 1966, showed $144,930,700 reinstatements of partial withdrawals, which turnover amounted to 25 percent of the Fund's assets during the six months period.[10/] The NASD noted in the court below that its chief economist had analyzed the dilutive effect of excessive use of the withdrawal-and-reinstatement privilege and, in so doing, had noted that in May 1966 a 9 percent drop in the net asset value of the Fund was accompanied by the highest level of withdrawals and redeposits on record, $82,000,000 and $86,000,000 respectively.[11/] The court below agreed with the conclusion of the Commission and the NASD that this type of speculative activity was harmful to the mutual funds themselves and to the interests of non-speculating "shareholders in the underlying mutual funds, since it 'diluted' their shares . . ." (A 777-778).

In March 1966, the Mutual Fund Plan Sponsors, Inc., a trade organization of sponsors of contractual plans, of which the defendant Growth

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10/ Ratzlaff's Deposition, Px 5 (Memorandum dated June 29, 1966, from Ray Moulden to the Commission's staff), pp. 2-3.

11/ Brief of Defendant, NASD, in Support of Its Motion for Summary Judgment and/or to Dismiss For Failure to State a Cause of Action Upon Which Relief Can Be Granted and/or Lack of Jurisdiction, p. 38.

Programs, Inc. was a member, admonished all sponsors of plans for the accumulation of mutual fund shares that use of the withdrawal-and-reinstatement privilege to ride the "up and down" sides of the markets was "an abuse of the withdrawal privilege" and "could be considered a violation of the principles imposed by the [NASD's] Rules of Fair Practice . . ." (Chorn Deposition, Px 115, pp. 2-3). The magnitude of the problem was brought to the attention of the NASD Investment Companies Committee by representatives of the Association of Mutual Fund Plan Sponsors and the Investment Company Institute and the staff of the Commission (Ratzlaff's Deposition, p. 8). Various approaches, including action by the Commission, had been discussed in conferences between the Commission's staff and the NASD with the joint ultimate determination [12/] that the problem should be handled by the NASD's publishing an interpretation of Article III, Section 1 of its Rules of Fair Practice, which section states:

> "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." CCH NASD Manual ¶ 2151 (1970). 13/

12/ Ratzlaff's Deposition, pp. 17-21.

13/ This rule was adopted by the NASD in 1939 and accepted by the Commission in that same year, at the time the Commission approved, as being consistent with the statute, the NASD's application for registration. 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). Section 15A(b)(8) of the Maloney Act, 15 U.S.C. 78o-3(b)(8), provided that the Commission could not register a national securities association unless the rules of such association were designed, *inter alia*, ". . . to promote just and equitable principles of trade . . . ." The rule has remained unchanged throughout the years.

On July 18, 1966, the Commission, having considered the NASD's draft of the interpretation which reflected various suggestions of the Commission's staff, advised the NASD that it "could proceed with the issuance and publication" of its proposed interpretation.[14/] On July 22, 1966, the Board of Governors of the NASD, pursuant to express authority in the NASD by-laws to make and issue interpretations of the NASD's Rules of Fair Practice,[15/] issued a formal "Interpretation with Respect to Contractual Plan Withdrawal and Reinstatement Privileges," effective August 1, 1966, as to all such privileges, regardless of when the contractual plans involved had originally been established.[16/] The interpretation reads:

> "It shall be deemed conduct inconsistent with just and equitable principles of trade and in violation of Section I of Article III of the Rules of Fair Practice for a member to use or encourage the use of what is commonly known as the withdrawal and reinstatement privilege afforded to planholders under contractual plans, whether single payment, periodic payment or fully paid, in a manner which is detrimental to the interests of the shareholders of the investment company issuing the security underlying the contractual plan." (A 53.)

This was followed by more detailed guidelines indicating, among other things, that the use of the withdrawal-and-reinstatement privilege should ordinarily be limited to once a year and the use of telephone or telegraph orders should

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14/ Brief of Defendant, NASD, in Support of its Motion for Summary Judgment and/or To Dismiss for Failure To State a Cause of Action Upon Which Relief Can be Granted and/or for Lack of Jurisdiction, Exhibit 2. Pursuant to the Commission's minute in this matter, the NASD was further advised that consideration should be given to indicating in the proposed interpretation that it was applicable to other redeemable shares issued by investment companies, as well as contractual plans. This suggestion was adopted.

15/ CCH NASD Manual, ¶ 1402, ¶ 1503 (1970).

16/ This interpretation appears in CCH NASD Manual ¶ 5261 (1970).

be prohibited.[17/] The interpretation also pointed out that ". . . the principles of this interpretation would also apply to similar misuse of any withdrawal and reinstatement privileges which might be made available

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17/ In elaboration, the NASD declared that practices detrimental to the interests of shareholders of the investment company issuing the securities underlying the contractual plan included, but were not limited to, the following:

"1. The suggestion, encouragement, or assistance to (or any arrangement which encourages or assists) a planholder in:

a) making repeated or excessive use of the withdrawal and reinstatement privilege (ordinarily, use of the privilege by a planholder more frequently than once during the period of a year will be viewed as excessive);

b) reinstating the investment within 90 days after withdrawing shares or cash;

c) making use of the withdrawal privilege within six months after the most recent investment in the plan, other than the reinvestment of a dividend or distribution. (This is not intended to interfere with the right of a planholder to liquidate all or a portion of his plan account or to withdraw his shares at any time, but is intended to restrict the use of the reinstatement privilege as to shares or cash which has been withdrawn during the six-month period);

d) using the privilege to provide funds for temporary investment in other securities;

e) using the privilege for the purpose of taking advantage of fluctuations in the net asset value per share of the investment company.

"2. Any arrangement, or the use of any arrangement, whereby a custodian bank or other person performing a similar function will accept telephone, teletype, or telegraphic requests or instructions for the withdrawal of shares or cash from a plan account, whether such requests or instructions are received from a member or from a planholder.

(continued)

to investors in connection with any other acquisition of share of open-end investment companies." (A 55).

Subsequent discussion between the Fund sponsor and NASD representatives resulted in a letter to the sponsor from the NASD, dated October 13, 1966, stating that certain revised procedures for the administration of the withdrawal-and-reinstatement privilege proposed by the Fund sponsor, although not as stringent as those referred to by the NASD Interpretation, would be deemed to constitute substantial compliance with the Interpretation, assuming that "natural attrition" would shrink the remaining speculative activity rapidly (Ratzlaff's Deposition, PX 8, p. 7, and Px 9, pp. 1-2). These adjusted procedures, however, did not result in the anticipated attrition; in fact, in November 1966 and July 1967, the aggregate value of transactions involving use of the privilege was $42,000,000 and $46,000,000,

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17/ (continued)

> "3. Any arrangement, or the use of any arrangement, whereby a custodian bank or other person performing a similar function will accept telephone, teletype, or telegraphic requests or instructions, or condition orders, to reinstate shares previously withdrawn from a plan account, whether such requests or instructions are received from a member or a planholder.
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> "4. Any arrangement, or the use of any arrangement, whereby a custodian bank will withdraw shares or cash from a plan account, or reinstate shares previously withdrawn, upon a power of attorney, executed by a planholder appointing a member or an associated person of a member, as the attorney of the planholder.
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> "This interpretation is directed primarily to the improper use of withdrawal and reinstatement privileges made available to planholders of contractual plans. However, the principles of this interpretation would also apply to similar misuse of any withdrawal and reinstatement privileges which might be made available to investors in connection with any other acquisition of open-end investment companies." CCH NASD Manual ¶ 5261 (1970) (A 54-55).

respectively, and in no month in between did the figure ever drop below $27,000,000 (Ratzlaff's Deposition Px 10, pp. 1-2). Thus, concluding that "on balance there has been a net increase in the dollar amount of these transactions," the NASD advised the Fund sponsor on August 28, 1967, and requested the Fund sponsor in turn to advise its programholders and the custodian bank on September 8, 1967, that henceforth the Fund sponsor would be required to comply strictly with the NASD Interpretation or it could be subject to disciplinary action (id.).

ARGUMENT

I. THE DISTRICT COURT PROPERLY DETERMINED THAT THE NASD INTERPRETATION IN QUESTION IS CLEARLY WITHIN THE POWER GRANTED THE NASD UNDER THE MALONEY ACT AND THAT THE PROMULGATION OF SUCH INTERPRETATION DID NOT VIOLATE DUE PROCESS OF LAW.

A. Contracts Entered Into With Others By Members of a Registered Securities Association Must Be Deemed To Be Subject To the Rules of Such Association If Effective Self-Regulation of Broker-Dealers Contemplated By the Maloney Act Is To Be Achieved.

In rejecting the "extremely narrow view of the issues" presented by the plaintiffs-appellants, the district court stated:

> "As even the most casual reader of the facts underlying the suit can tell, however, this is not simply a garden variety breach of contract suit . . . . [T]he path to a correct decision is lined with deep-rooted public policy considerations set out by Congress primarily in the Maloney Act." (A 779)

The Maloney Act entrusted to registered national securities associations major responsibilities in the administration and enforcement of certain aspects of the federal securities laws. Self-regulatory power was considered to be a preferable "alternative [to the] pronounced expansion of the organization of the Securities and Exchange Commission."

S. Rep. No. 1455 at 3-4 and H.R. Rep. No. 2307 at 4-5, 75th Cong., 3d Sess. (1938). This Congressional grant of self-regulatory power has been upheld in Nassau Securities Service v. Securities and Exchange Commission, 348 F. 2d 133, 136 (C.A. 2, 1965) and R.H. Johnson & Co. v. Securities and Exchange Commission, 198 F. 2d 690, 695 (C.A. 2), certiorari denied, 344 U.S. 855 (1952). In both cases the court emphasized the presence of Commission supervision over NASD's rules and disciplinary action. Hence, the effect of NASD rules and orders on contracts entered into by its members should be comparable to the controlling effect given a rule or order of a governmental regulatory agency, at least as to those rules the NASD is required by law to have in order to be a registered national securities association. As we have seen, the NASD's rule of fair practice here involved was designed to fulfill the requirement of the Maloney Act that the association must have rules "designed . . . to promote just and equitable principles of trade . . ." (p. 10, supra). Because the defendant Growth Programs is a member of the NASD, its contract with the appellants must be assumed to have been entered into subject to this rule of fair practice, and to all rules of the NASD.[18/]

That rules of a self-regulatory organization under the supervision of the Commission sometimes have the force of law was recently illustrated in Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F. 2d 135

18/ Section 4 of Article I of the by-laws of the NASD provides that in order to become a member of the NASD, an applicant must agree to abide by, comply with, and adhere to, inter alia, all the rules and regulations of the NASD, and all rulings, orders, directions and decisions of, and penalties imposed by, the Board of Governors or any duly authorized NASD committee. CCH NASD Manual ¶ 1104 (1970).

(C.A. 7), certiorari denied, 396 U.S. 838 (1969), which held that a complaint based on a violation of a rule of the New York Stock Exchange by a member may be actionable. The court determined that it had jurisdiction under Section 27 of the Securities Exchange Act, giving district courts "jurisdiction of 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." In that case, the plaintiff, the trustee of a bankrupt, alleged that because of the callous disregard by the defendant, a brokerage firm and member of the Exchange, of the "Know Your Customer" rule of the Exchange (Rule 405), the financially irresponsible president of the bankrupt was able to use the defendant's facilities for purposes of speculating with funds converted from the bankrupt's customers. The court held that a violation of Rule 405 of the New York Stock Exchange "may be actionable as a 'duty created by this chapter' inasmuch as Rule 405 was promulgated in accordance with . . . [provisions] of the Act" (id. at 142). It stated: "The touchstone for determining whether or not the violation of a particular rule [of the Stock Exchange] is actionable should properly depend upon its design 'for the direct protection of investors'" (id.). Cf., Colonial Realty Association v. Bache, 358 F. 2d 178, 180-183 (C.A. 2), certiorari denied, 385 U.S. 817 (1966).

Here, there is involved an interpretation of a rule of a self-regulatory body under the jurisdiction of the Commission adopted, pursuant to the Maloney Act provisions in the Securities Exchange Act, "for the direct protection of investors." Interpretations of rules are a necessary

adjunct to the NASD's rulemaking power. As we have noted, p. 11, supra, the NASD's by-laws, which Growth Programs as a member of NASD agreed to abide by, explicitly give the Board of Governors the power to make and issue interpretations. 19/ The interpretation here challenged was adopted only after consultation with the Commission's staff 20/ and agreement of the Commission itself that this interpretation was appropriate. 21/ Specific applications of interpretations by the NASD's Board of Governors of the Rules

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19/ In addition to the Interpretation with Respect to Contractual Plan Withdrawal and Reinvestment Privileges, which appears in CCH NASD Manual (1970) at page 5089, matters dealt with by the NASD by means of interpretation have covered a broad range of subject areas and may be found in CCH NASD Manual (1970) at the following pages: Advertising, 2017; "Free-Riding and Withholding," 2039; Execution of Retail Transactions in the Over-the-Counter Market, 2035; NASD Markup Policy, 2058; Manipulative and Deceptive Quotations, 2071; Transactions Between Members and Non-Members, 2099; Transactions Effected for Personnel of Other Members, 2110; The Effect of a Suspension or Revocation of the Registration, If Any, of a Person Associated with a Member or the Barring of a Person from Further Association with a Member, 2114; Rates of Return, 5022; Sales Literature Featuring Income, 5023; Custodial Service, 5025; Comparisons, 5026; Sales Commissions 5031; "Special Deals," 5092; Dealer Compensation of Salesmen for Sales of Investment Company Shares, 5094; Selling Dividends, 5264; Prompt Payment by Members for Shares of Investment Companies, 5097; Breakpoint Sales, 5097; Arranging Loans, 5098; Review of Corporate Financing, 2020.

20/ See p. 11, supra. As a matter of policy such consultations are always had, although, unlike the adoption of a new rule, an interpretation of an existing rule is not required to be filed with the Commission prior to its promulgation. The interpretation here involved was filed with the Commission as a supplement to the NASD's registration statement pursuant to the requirements of Section 15A(j) of the Act and Commission Rule 15Aj-1 under the Act, 17 CFR 240.15Aj-1. See Form X-15A-1 of the Commission and Instruction 5 of that form, 17 CFR 249.802.

21/ The district court referred to (1) the Commission's review of the NASD's interpretation, (2) the Commission's expressed concern regarding excessive use of the in-and-out privilege which it noted in

(continued)

of Fair Practice have previously been considered by both the Commission and the courts. For example, the validity of the NASD's "mark-up" policy (generally limiting the gross spread or mark-up charged by NASD members to 5% over the current market price), which is also in part an interpretation of its rule on just and equitable principles of trade, was first considered by the Commission in 1944. See National Association of Securities Dealers, Inc., 17 S.E.C. 459 (1944). The validity of that interpretation has also been upheld by the courts. Handley Investment Company v. Securities and Exchange Commission, 354 F. 2d 290 (C.A. 10, 1965); Samuel B. Franklin & Co. v. Securities and Exchange Commission, 290 F. 2d 719 (C.A. 9), certiorari denied, 368 U.S. 889 (1961).

The NASD's interpretation, as we have seen, is wholly consistent with the mandate of the Maloney Act to "protect investors and the public

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21/ (continued)

its report to Congress on investment company growth (supra, p. 8) and (3) the amicus brief filed by the Commission with that court (A 787). The court concluded that since it had received the benefit of the expertise of the federal agency charged with supervision of the NASD and with responsibility in this area, ". . . the rationale for requiring exhaustion [of administrative remedies] is very weak in this case . . ." (A 787). In that connection, the district court noted that the plaintiffs had not utilized the provision in the Maloney Act, 15A(k)(1), 15 U.S.C. 78o-3(k)(1), which "clearly contemplates extensive SEC review" of rules promulgated by the NASD (A 786). That section provides that the Commission may "abrogate any rule of a registered security association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing . . . or otherwise to protect investors. . . ." In light of the fact that the section involved gives the Commission substantial latitude of discretion in determining whether to institute a proceeding to "abrogate" a NASD rule, it would be unlikely, for the reasons noted by the district court, that the Commission would elect to commence such a proceeding to review the NASD's interpretation here involved. Hence, it would seem that it is unnecessary for this Court to consider whether, under the doctrine of either primary jurisdiction or exhaustion of administrative remedies, it would ordinarily be appropriate to refer such a matter to the Commission for its views before continuing with judicial review.

interest" and with its responsibility to hold its members to high standards of commercial honor and just and equitable principles of trade. Because excessive use of the withdrawal-and-reinstatement privilege necessarily places a burden on a mutual fund to maintain a highly liquid position and dilutes the interests of shareholders in the fund, it would hardly be expected that the Board of Governors of the NASD would not construe this practice as contrary to fair and equitable principles of trade within the meaning of its Rules of Fair Practice. Certainly the fact that the other defendants had permitted the plaintiffs to use the privilege as a speculative vehicle cannot affect the validity of the NASD's interpretation that it is improper for it to be so used.

That an action by a self-regulatory body created under the scheme of the Securities Exchange Act, such as the NASD, may legitimately have a regulatory effect upon a non-member, as well as upon one of its members, was recognized by the Supreme Court in Silver v. New York Stock Exchange, 373 U.S. 341 (1963). The Court there observed that duties imposed by the Securities Exchange Act upon the stock exchanges with respect to the adoption and enforcement of their rules involve both exchange members and non-member brokers and often weigh more heavily against the latter than against the former. It then stated:

> "One aspect of the statutorily imposed duty of self-regulation is the obligation to formulate rules governing the conduct of exchange members. The Act specifically requires that registration cannot be granted 'unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable

principles of trade . . . ,' §6(b), 15 U.S.C. §78f(b). In addition, the general requirement of §6(d) that an exchange's rules be 'just and adequate to insure fair dealing and to protect investors' has obvious relevance to the area of rules regulating the conduct of an exchange's members.

"The §6(b) and §6(d) duties taken together have the broadest implications in relation to the present problem, for members inevitably trade on the over-the-counter market in addition to dealing in listed securities, and such trading inexorably brings contact and dealings with non-member firms which deal in or specialize in over-the-counter securities. <u>It is no accident that the Exchange's Constitution and Rules are permeated with instances of regulation of members' relationships with non-members including nonmember broker-dealers</u>" (emphasis supplied) (footnotes omitted). 373 U.S. at 353-354.

* * *

"Rules which regulate Exchange members' doing of business with nonmembers in the over-the-counter market are therefore very much pertinent to the aims of self-regulation under the 1934 Act." 373 U.S. at 355.

* * *

"<u>The Exchange's enforcement of such rules inevitably affects the nonmember involved, often (as here) far more seriously than it affects the members in question. The sweeping of the nonmembers into the currents of the Exchange's process of self-regulation is therefore unavoidable</u>" (emphasis supplied). 373 U.S. at 356.

Subsections (b) and (d) of Section 6 of the Securities Exchange Act, cited in <u>Silver</u>, dealing with stock exchanges, have provisions for rules governing membership comparable to those in Sections 15A(b)(8) and 15A(b)(9) of the Maloney Act, dealing with registered associations of securities dealers. Indeed, Section 6(b) includes a requirement for rules to promote "just and equitable principles of trade"--the identical language contained in

Section 15A(b)(8), pursuant to which the rule here involved was adopted. As recognized in Silver with respect to the stock exchange and its members, the duties imposed by the NASD "have the broadest implications in relation" to the case at bar because members of the NASD inevitably trade with customers, such as the appellants who are not members of the NASD. The rules of the NASD that regulate NASD members doing business with non-members are not only pertinent to the aims of self-regulation under the 1934 Act but essential if self-regulation is to be effective; and, as evidenced by the instant case, the NASD's "enforcement of such rules may inevitably affect the non-member involved. . . ." Hence, the conclusion seems logically to follow that "the sweeping of the non-members into the currents of the [NASD's] process of self-regulation is therefore unavoidable."

Accordingly, we submit that it would be wholly contrary to the regulatory aims of the Act for this Court to hold that the NASD's interpretation of its rule is not applicable to the contracts here involved. If, as here, a member of the NASD enters into a relationship with a non-member, which relationship is contrary to "just and equitable principles of trade" because of its unfairness to numerous other investors, the non-members should not be permitted to prevent the NASD from terminating that relationship; otherwise the NASD will be unable to perform the important functions intended by Congress for such an association.

B. There Was No Denial of Due Process in the Issuance of the Interpretation.

The interpretation by the NASD of its rule of fair practice here involved was essentially a statement of its view of the appropriate standard

of conduct for its members with relation to the withdrawal-and-reinstatement privilege made necessary by the increasing use of that privilege in recent years in a manner inconsistent with the original purpose of that privilege. The district court noted:

> "Withdrawal and reinvestment clauses similar to the one involved in this case apparently have been routinely included in investment plan contracts since the 1930's . . . .
>
> "From their inception up until 1965, the withdrawal-reinvestment privileges apparently were exercised sparingly by single investment planholders. In 1965, however, Defendant Growth and some of the larger class plaintiffs devised an investment contract designed to facilitate use of the withdrawal-reinvestment privilege as a tool for speculating on short [swings] . . . in the market rather than merely for conserving the underlying investment during a personal financial crisis" (A 775-776).

The interpretation, the merits of which the appellants do not dispute, merely set forth the NASD's view that the speculative use of the privilege violated its Rule of Fair Practice respecting just and equitable principles of trade and merely set forth guidelines for determining whether the privilege was being abused. In National Association of Securities Dealers, 17 S.E.C. 459 (1944), the Commission was faced with a contention, similar to the one raised here, that the promulgation of an interpretation instead of a rule was a denial of due process. In upholding the NASD's announcement of its 5 percent markup policy through an interpretation of the same Rule of Fair Practice involved here rather than through the promulgation of a new rule, the Commission emphasized that "the board of governors established no new standard" with its interpretation (id. at 466):

> "As we interpret the board's action, it constitutes not a rule but notice to the membership of what the current trade practice is found to be and of what

> procedure the board advises the committees to follow in trade practice cases" (id. at 468). 22/

Likewise, here, the NASD merely gave advance notice of what it would consider to be a violation of the professional standard regarding proper use of the withdrawal-and-reinstatement privilege, which standard was in accord with the accepted conduct of its members.

In merely reaffirming and enforcing the original purpose for which the privilege was created, there was no need on the part of the NASD to advise or consult with any specific company. 23/ Indeed, even when promulgating a rule, the NASD is not required by the Maloney Act to conduct hearings or solicit public comments. The procedure contemplated by the statute is contained in Sections 15A(b)(6), 15A(j), 15 A(k)(1) and (2), 15 U.S.C. 78o-3(b)(6, 3(j), 3(k)(1) and (2). The statute requires that the NASD "assure" a fair representation of its members in the adoption of any rule of the

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22/ The Commission dismissed the petition in National Association of Securities Dealers for abrogation of the "alleged rule" since, as the Commission had determined, the announcement of the 5 percent markup policy was an interpretation and not a rule (id. at 470). As noted supra p. 18, the validity of the interpretation in National Association of Securities Dealers was upheld by the courts.

23/ Appellants cite Philadelphia Co. v. Securities and Exchange Commission, 175 F. 2d 808 (C.A. D.C. 1948), for the proposition that failure by the NASD or the Commission to conduct hearings on the interpretation rendered such interpretation "invalid and void" (Br 36). Appellants failed to note that that case was vacated as moot. 337 U.S. 901 (1949). Moreover, it did not purport to involve an interpretation of an existing rule but, rather was an attempt by the Commission to change one of its own rules in a manner that would have affected only a single holding company system registered with the Commission pursuant to the Public Utility Holding Company Act of 1935. The court of appeals held that, for this reason, procedures applicable to adjudication rather than rulemaking should have been followed.

association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs," Section 15A(b)(6). Pursuant thereto the NASD has set up a Board of Governors charged with the management and administration of its affairs. As set forth in its bylaws, Article IV, Sections 2 and 6(a), the Board is "composed of 24 members," 21 of whom are to be nominated "as nearly as practicable, to secure appropriate and fair representation . . . of all classes and types of firms engaged in the investment banking and securities business."[24/] To assure compliance with the statutory requirements, this Commission is specifically authorized by the Act to alter or supplement the rules of the NASD with respect to the method of choosing officers and directors, Section 15A(k)(2)(C). Moreover, the Act gives the Commission plenary power to disapprove proposed NASD rules or rule amendments without the necessity of notice or opportunity for hearing to any person, including the NASD.[25/] Appellants have not raised the contention that the Board of Governors did

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24/ CCH NASD Manual ¶ 1402, 1406 (1970). The other three members of the Board of Governors are the President of the Association and one representative each from the investment company and insurance company segments of the securities business, all of whom are chosen by the 21 members. Article IV, Sections 3(e) and (f); Article V, Section 2; CCH NASD Manual ¶ 1403; 1452 (1970).

25/ Section 15A(j), 15 U.S.C. 78o-3(j). We note, however, that in connection with proposed adoption of rules or interpretations, consultations are had between the NASD and Commission staffs before NASD submission to the Commission. As a result of such consultations, the Commission rarely has had occasion to disapprove a proposed rule. The statutory power giving the Commission this veto power over new rules and rule amendments may be compared with the other quasi-legislative supervisory powers vis-a-vis NASD rules given to the Commission which do call for notice and opportunity for hearing, under the circumstances specified in those sections. Sections 15A(k)(1) (proceeding to abrogate an NASD rule) and 15A(k)(2) (proceeding to alter or supplement an NASD rule).

not fairly represent the members of the NASD [26/] or that they had requested, and were denied, an opportunity to be heard respecting the application of existing NASD rules to their particular situation. Cf., Silver v. New York Stock Exchange, supra, 373 U.S. 341. We should note in the latter connection that Growth Programs, Inc., was afforded an opportunity to and did present, by a series of letters, its views on the interpretation to the Board of Governors prior to the advice by the NASD to that member that it comply therewith (see discussion, supra, pp. 13-14) (Ratzlaff's Deposition, Px. 8, 9, 10, 11 and 12).

Even if it should be assumed, however, that the interpretation by the NASD, instead of being an expression of what its rule has long encompassed, represented a change in its views as to what the basic standards mean or to what situations they should be applied, that change should have no lesser effect on the members' contracts than would a change in the governing law or in a Commission or court interpretation of that law. See, e.g., Norman v. Baltimore & Ohio Railroad Co., 294 U.S. 240, 305 (1935), which states that "contracts must be understood as having been made in reference to the possible

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26/ Here, both an appropriate Committee and the Board of Governors of the NASD, as well as the Commission, considered the abuses of the withdrawal-and-reinstatement privilege. The Record shows that the Investment Companies Committee of the NASD recognized that this privilege "was being used for a purpose for which it had never been intended and in a way that was potentially harmful to the funds concerned and their shareholders" (Ratzlaff's Deposition, p. 14); that the Committee discussed these problems with staff officials of this Commission, who expressed their concern over "the potential for harm to the funds involved" (id. at 20) and were considering the possibility of direct Commission action; and that at a meeting of the Investment Companies Committee in March 1966, it was determined to have an interpretation drafted (id. at 21-22). After submitting the draft to the members of the Committee for comment, the interpretation was proposed to the NASD Board of Governors in May of 1966. Thereafter the Board of Governors adopted the interpretation, having been furnished copies of it in advance of the meeting, and had it published on July 22, 1966 (id. at 24-25; 33).

exercise of the rightful authority of the Government, and that no obligation of a contract 'can extend to the defeat' of that authority." The appellants appear to concede the authority of the NASD to cancel existing contractual rights if the continuation of such rights is 'clearly illegal' (Br 22). It has been demonstrated that the rights here involved--i.e., the rights to use the withdrawal-and-reinstatement privilege to speculate without payment of sales fees--are clearly contrary to the Maloney Act. Appellants also state:

> "Even should we concede the right of NASD to regulate contractual arrangements entered into by its members with the public as to the future, we vehemently deny its right to cancel existing contracts unilaterally" (Br 19-20).

It would seem that the public policy which dictates that a person may not in the future contract for unlimited use of the privilege must also be deemed to govern contracts already in existence. For, as the NASD concluded, given the number of dollars already invested in the contractual right of unlimited use of the withdrawal-and-reinvestment privilege the abuse of this privilege could not meaningfully be corrected by applying the interpretation only to future contractual plans (Ratzlaff's Deposition, p. 23). Moreover, as we have pointed out (supra, p. 13), the NASD agreed to permit the fund sponsor to continue the administration of the in-and-out privilege as to existing contract holders under conditions less stringent than those suggested in the NASD interpretation on the assumption that "natural attrition" would reduce the speculative activity rapidly. It was not until it became apparent that not only had the anticipated attrition failed to materialize but that there had been a net

increase in the dollar amount of the in-and-out transactions that the NASD advised the fund sponsor that it must comply strictly with the interpretation.

Moreover, the facts presented in the case at bar suggest that plan-holders had constructive, if not actual, knowledge of the sponsor's obligation to comply with all existing and prospective standards of conduct established by the NASD for adherence by its members. All purchasers of the contractual plans in question were given notice that Growth Programs, Inc., the sponsor, was a member of the NASD by an express statement on page nine of the prospectus:

> "The Sponsor is a Delaware corporation organized in November, 1961. It is a registered broker/dealer under the Securities Exchange Act of 1934 and a member of the National Association of Securities Dealers, Inc., and is primarily engaged in the distribution of Programs through broker/dealer members of the association" (A 173).

The obligation on the part of Growth Programs to conform to the NASD's requirements would thus appear to be a clearly implied condition pursuant to which the single-payment contractual plans involved herein were purchased.

Since the interpretation in question involved only a statement of the accepted conduct of many NASD members and a reaffirmation of the original purpose of the withdrawal-and-reinstatement privilege, there was no need for the NASD to seek comments in advance from the companies involved, particularly in view of the conclusion reached by the Commission in its study of mutual funds, noted <u>supra</u>, p. 8. Moreover, the NASD did substantiate its conclusion that abuse of the privilege was detrimental to

investors in the underlying fund as well as the fund itself.[27/] In the

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27/ Appellants' claim that the NASD's conclusion as to the potential harm resulting from unlimited use of the withdrawal-and-reinstatement privilege is unfounded because Television-Electronics Fund (the underlying fund of the contractual plans here involved) has, allegedly, never been faced with a liquidity crisis due to withdrawal activities on the part of programholders (Br 27). It is not altogether clear that the millions of dollars of withdrawals and reinstatements made pursuant to the in-and-out privilege (see pp. 9, 13-14, supra) caused no liquidity stresses. According to Mr. Chorn, on behalf of Growth Programs, the use of the privilege had reached such proportions that "Growth Programs voluntarily began to consider means of dampening the enthusiasm of certain dealers for the use of the partial withdrawal and reinvestment privilege to take advantage of short-term swings in the stock market" (Ratzlaff's Deposition, Px 8, p. 4). Thus Growth Programs in its prospectus dated April 26, 1966, expressly reserved the right to limit exercise of the privilege to four times a year (id.). Mr. Chorn stated that "(W)e [Growth Programs] are in complete accord with the purpose of the Interpretation . . ." (id. at 6). As we have seen (p. 9, supra), a representative of the fund's sponsor stated that use of this privilege caused a "burden" on the sponsor;and we have seen that in a six months period the turnover resulting from use of the privilege amounted to 25% of the total assets of the fund.

In any event, the fact that any one fund has not had a liquidity problem in the past does not invalidate the NASD's conclusion that this is a potential, if not present, evil. Moreover, the interpretation was designed to correct and prevent other problems as well, for example, the dilution of the interests of non-speculating shareholders in the fund. The fact that one of a number of evils the interpretation was intended to remedy and prevent may not be present in a particular case by no means renders the interpretation inapplicable or erroneous. See North American Co. v. Securities and Exchange Commission, 327 U.S. 686, 710-711 (1946), in which the petitioners claimed that they should be exempted from the operation of Section 11(b)(1) of the Public Utility Holding Company Act of 1935, which requires every public utility holding company to limit its operations to a single integrated public utility system:

> "The contention apparently is that §11(b)(1), as applied to North American, is unconstitutional since none of the evils that led Congress to enact the statute is present in this instance. But if evils disclosed themselves which entitled Congress to legislate as it did, Congress had power to legislate generally, unlimited by proof of the existence of the evils in each particular situation. Section 11(b)(1) is not designed to punish past offenders but to remove what Congress considered to be potential if not actual sources of evil."

preface to the interpretation, the NASD gave examples of why a fund might be forced to maintain a liquid position without regard to any investment objectives:

> "reinstatement sales alone, i.e., replacement of cash previously withdrawn, in May, 1966, are estimated to have amounted to $100,000,000.
>
> "One particular investment company underwent a turnover equivalent to 25 percent of its entire assets during a recent six-month period, as a result of planholders withdrawing and putting back cash." CCH NASD Manual ¶ 5261 (1970).

In addition, in considering adoption of the interpretation, the Board of Governors of the NASD reviewed a report which indicated that sales of single payment investment contracts with the withdrawal-and-reinstatement privilege "represented an increasing portion of a fast growing segment of the securities industry and that the problem could be expected to increase."[28/]

In the light of the foregoing, the district court properly concluded:

> "On the basis of the voluminous record in this proceeding, we hold that the NASD interpretation questioned by the Plaintiffs is clearly within the power grantedthe NASD by the Maloney Act; that it was issued pursuant to proper procedure; and that it is reasonable." (A 787)

28/ Brief of defendant NASD, *supra*, note , p. 27.

II. THE DISTRICT COURT PROPERLY DETERMINED THAT THE ISSUANCE BY THE NASD, WITH COMMISSION CONCURRENCE, OF THE INTERPRETATION OF ITS EXISTING RULE OF FAIR PRACTICE DID NOT CONSTITUTE A VIOLATION OF THE ANTITRUST LAWS.

The Supreme Court has had one occasion to consider the standards to be utilized in reconciling the sometimes conflicting policies of the antitrust laws and the statutory scheme in the Securities Exchange Act for self-regulation, subject to Commission supervision, of the securities industry. In Silver v. New York Stock Exchange, supra, 373 U.S. 341, Silver, an over-the-counter broker-dealer in securities who was not a member of the New York Stock Exchange, arranged for direct-wire and ticker connections with several member firms of the Exchange. These wire connections were essential to his business. The Exchange granted "temporary approval" for them but thereafter, without prior notice to Silver, the Exchange directed its members to discontinue the connections, as required by rules of the Exchange. Notwithstanding repeated requests, officials of the Exchange refused to grant Silver a hearing or even to inform him of the reasons for the discontinuance of the wire services. Instead, Silver was repeatedly told it was the policy of the Exchange not to disclose the reasons for such action. The issues before the Supreme Court related to the cause of action asserted by Silver against the Exchange and its members, contending that their collective refusal to continue the direct-wire connections violated the antitrust laws.

In Silver, the Supreme Court stated at the outset that, although it was "plain" that the collective action of the Exchange and its members ("in simple terms, a group boycott") would, ". . . had it occurred in a context

free from other federal regulation, constitute a per se violation" of the antitrust laws (id. at 347), ". . . the presence of another statutory scheme, that of the Securities Exchange Act of 1934 . . ." prevented such a result (id. at 349).[29/] The Court noted the difficult problem arising "from the need to reconcile pursuit of the antitrust aim of eliminating restraints on competition with the effective operation of a public policy contemplating that securities exchanges will engage in self-regulation which may well have anti-competitive effects in general and in specific applications"

29/ It appears that plaintiffs-appellants argue (Br Point IV, pp. 43-53) that the action taken by the NASD is a per se violation of the antitrust laws. It is clear, however, from the language of Silver quoted in the text, and the holdings of courts which have considered the question, that the existence of the statutory scheme for self-regulation under the Securities Exchange Act prevents a finding of per se violation of the antitrust laws. See also Thill Securities Corporation v. New York Stock Exchange, CCH Fed. Sec. L. Rep. ¶ 92,756 (C.A. 7, August 27, 1970); Kaplan v. Lehman Brothers, 371 F. 2d 409 (C.A. 7), certiorari denied, 389 U.S. 954 (1967), rehearing denied, 390 U.S. 912 (1968).

And cf., Baum v. Investors Diversified Services, Inc., 286 F. Supp. 914 (N.D. Ill., 1968), aff'd on other grounds, 409 F. 2d 872 (C.A. 7, 1969), which holds that an investment company practice approved by the Commission pursuant to its regulatory powers under the Investment Company Act cannot be attacked as illegal per se under the antitrust laws. In ruling that the system of cumulative quantity discounts in the sale of mutual funds is immune from attack under the Robinson-Patman Act, the district court stated that:

> ". . . a challenge based upon the argument that the system [of quantity discounts] is a per se violation of the Robinson-Patman Act, cannot succeed, since the system exists pursuant to a statutorily authorized rule of the SEC." Id. at 927.

(id. at 349). The "proper approach," stated the Supreme Court, requires ". . . an analysis which reconciles the operation of both statutory schemes with one another rather than holding one completely ousted." Noting, with respect to the regulation of exchanges, that the Securities Exchange Act contained "no express exemption from the antitrust laws or, for that matter, from any other statute" the Court stated that any repealer of the antitrust laws "must be discerned as a matter of implication, . . ." and "only to the minimum extent necessary" "to make the Securities Exchange Act work . . ." (id. at 357.)

The Court held that, since there had been no oversight by the Commission of the New York Stock Exchange's application of its rules as to the use of private wire connections by members with non-members, court review was appropriate under the antitrust laws. In reaching this conclusion, the Court noted that the Securities Exchange Act ". . . does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules" (id. at 357). This "absence of Commission jurisdiction," said the Court, contributes to the solution of the problem (id. at 358). The Court indicated that some form of review of exchange self-policing, whether by the administrative agency or by the courts, was necessary. Since there was no agency check on the action of the Exchange in that particular case ". . . it follows that the antitrust laws are peculiarly appropriate as a check upon anticompetitive acts of exchanges which conflict with their duty to keep their operations and those of their members honest and viable" (id. at 360). Noting that the statutory scheme

of the Securities Exchange Act "is not sufficiently pervasive to create a total exemption . . ." of the stock exchanges from liability under the antitrust laws, the Court nevertheless stated that ". . . it is also true that particular instances of exchange self-regulation which fall within the scope and purposes of the Securities Exchange Act may be regarded as justified in answer to the assertion of an antitrust claim" (id. at 360-361).

The Court in Silver held that the act of self-regulation there involved was not justified ". . . because the collective refusal to continue the private wires occurred under totally unjustifiable circumstances" (id. at 361). The Court emphasized that there must be some method for telling a protesting non-member of the Exchange why a rule was being invoked so as to harm him and allowing him an opportunity to reply. The Court further noted that the antitrust court might perform its functions more effectively if the Exchange would "illuminate the circumstances under which it has acted" (id. at 363).

The action of the NASD here under review is a most direct manifestation of the goal of the Securities Exchange Act to protect investors. In Silver, as well as in almost all of the other cases cited by appellants in the antitrust portion of their brief, the challenged actions were much more related to a possible elimination of competition between business competitors. Here, in the ultimate analysis, is an action taken by a self-regulatory body governing conduct of brokers in the over-the-counter market, with the active approval of the Commission, intended solely to protect the potentially millions of public investors in mutual funds from the excessive and abusive use of speculative devices by a relatively small number of investors. In our view the action taken by the NASD was necessary to make the Securities

Exchange Act work.

Unlike the action of the Exchange in Silver--discontinuing without explanation the wire and ticker services theretofore afforded Silver--here the reasons for the NASD interpretation have been fully set forth and no one is in the dark about them. Here, all the circumstances under which the self-regulatory agency has acted have been "illuminated." Hence, the fundamental unfairness which troubled the Supreme Court in Silver--the refusal to divulge the reasons for the Exchange's actions--is not present here.

We do not urge that the statutory scheme of self-regulation by national securities associations under government oversight (while even somewhat more pervasive, in respects material here, than the analogous form of regulation over national securities exchanges with which the Supreme Court dealt in the Silver case (see pp. 35-36, infra)) permits the NASD and its members to enjoy a blanket immunity from liability under the antitrust laws for whatever singular or collective action they may take. Rather, under the "guiding principle to reconciliation" set forth by the Supreme Court in the Silver case, 373 U.S. at 357--antitrust immunity to the minimum extent necessary to make the Securities Exchange Act work--there must be such immunity here. Unlike Silver, which involved the action of the Exchange directed at one individual and without governmental oversight or guidance with regard to that action, here, as we have noted earlier in this brief, the action of the NASD is intended to be of wide application and was taken not only under the direct oversight of the Commission but, moreover, in accordance with the Commission's view expressed in a report to Congress

and after discussions between the staffs of the NASD and the Commission.[30]

The Silver case and the Thill case (see footnote below) are also distinguishable by reason of the specific oversight given to this Commission in the antitrust area over a national securities association. While the Securities Exchange Act (and its legislative history) deals with the anti-competitive aspects of exchange rules only by implication, the Maloney Act explicitly provides that the Commission is to consider antitrust effects in connection with the rules of a national securities association. Section 15A(b)(8) requires, *inter alia*, that a registered association's rules be "not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any

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30 / The presence of active Commission oversight also distinguishes the present case from Thill Securities Corporation v. New York Stock Exchange, CCH Fed. Sec. L. Rep. ¶ 92,756 (C.A. 7, August 27, 1970, set forth in pp. 1-7 of the appendix to the appellants' brief in this Court). In Thill, which involved the antitrust implications of the New York Stock Exchange's anti-rebate rule (alleged to have effectively denied non-members access to the Exchange), the court of appeals reversed the decision of the district court, which had granted summary judgment for the Exchange, and remanded the case for full proceedings to determine whether the rule in question is "necessary to make the Act work," the standard established by Silver. Judge Campbell, in his opinion for the court, rejected the view of the district court in that case that " . . . the mere possibility of SEC review wraps the conduct of the Exchange in an impregnable shield of antitrust immunity." Judge Campbell noted that there was no evidence in the record ". . . as to the extent to which the challenged rule is subject to actual review by the SEC; there is no evidence as to what in the regulatory scheme 'performs the antitrust function'; and, most notably, there is no evidence as to why the anti-rebate rule must be preserved as 'necessary to make the Securities Exchange Act work'" (*id.* at 99,296).

schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." In addition the association's rules are required under that subsection "to remove impediments to and perfect the mechanism of a free and open market." These provisions are enforced by the Commission not only in connection with its findings when an association seeks to register but also through the Commission's power to abrogate rules when necessary to "effectuate the purposes" of the Securities Exchange Act (Section 15A(k)(1)), to disapprove an association's rule proposals in advance of their effective date (Section 15A(j)), and to review disciplinary proceedings of an association (Section 15A(h)(1)).[31/]

Moreover, as the Supreme Court noted in Silver, the Securities Exchange Act contains, with regard to exchange regulation, "no express exemption from the antitrust laws or, for that matter, from any other statute" (id. at 357). On the other hand, Section 15A(n) of the Maloney Act provides:

> "If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect [June 25, 1938], the provision of this section shall prevail."

31/ Chief Judge Swygert, concurring in the Thill case, rejected the argument made by the New York Stock Exchange that the absence of discussion of the anti-competitive aspects of exchange rules in the legislative history of the Securities Exchange Act constituted an implied repeal of the antitrust laws for rules within the domain of exchange regulation, stating: "This argument seems especially weak in light of the Maloney Act, 15 U.S.C. §§78a-hh, enacted in 1938, which expressly provides for consideration by the SEC of anti-competitive practices in analogous regulation of registered securities associations. Thus the availability of SEC review of exchange self-regulation under Section 19(b) is, in my view, irrelevant to the scope of exchange exemption from the antitrust laws." (Id. at p. 99,301).

This provision has been interpreted by the Supreme Court as conferring upon a national securities association a measure of antitrust immunity:

> ". . . [T]he typical method adopted by Congress when it has lifted the ban of the Sherman Act is the scrutiny and approval of the designated public representatives . . . . And see the Maloney Act (§15A of the Securities Exchange Act of 1934; 52 Stat. 1070) providing for the formation of associations of brokers and dealers with the approval of the Securities and Exchange Commission and establishing continuous supervision by the Commission over specified activities of such associations." 32/

In summary the concept of self-regulation embodied in the Maloney Act necessarily contemplates collective action by national securities associations, such as the NASD, together with their members in promulgating and enforcing rules. As noted in its legislative history, the statutory scheme of the Maloney Act

> "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." S. Rep. No. 1455 at 4 and H.R. Rep. No. 2307 at 4-5, 7th Cong., 3d Sess. (1938).

Where, as here, the self-regulatory action is taken with the express concurrence of the Commission to eliminate injury to investors that has

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32/ United States v. Socony Vacuum Oil Co., 310 U.S. 150, 227, n.60 (1940). See also International Association of Machinists v. Street, 367 U.S. 740, 810 n.16 (1961) (dissenting opinion of Mr. Justice Frankfurter), indicating that "Sections 15A(i) and (n) of the Exchange Act authorize the NASD to formulate rules which stipulate that members shall refuse to deal with nonmembers with immunity from the antitrust laws."

been pointed out by this Commission, the self-regulatory body should not have to risk sanctions under the antitrust laws. If in these circumstances the self-regulatory organization cannot, under appropriate Commission supervision, act freely to govern its members in their dealings with third parties as well as with other members, the regulatory design of Congress would be frustrated.

CONCLUSION

For the foregoing reasons, the order of the district court should be affirmed.

Respectfully submitted,

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