Powell - Berg

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 71-1658

HAGEN INVESTMENTS, INCORPORATED, and
EDWARD J. HAGEN,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review of an Order of
the Securities and Exchange Commission

ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

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COUNTERSTATEMENT OF THE ISSUE PRESENTED

Did the Securities and Exchange Commission err in holding that, pursuant to the statutory scheme of flexible self-regulation of brokers and dealers in the over-the-counter markets embodied in the Securities Exchange Act of 1934, the Board of Governors of the National Association of Securities Dealers ("NASD") correctly sanctioned petitioners for their inability promptly and properly to consummate executory securities transactions, in violation of emergency rules of the NASD, where the

general inability of brokers and dealers to consummate such transactions was resulting in (1) late or no delivery of securities to customers who already had paid for them; (2) financial instability for some brokers and dealers; and (3) loss of investor confidence in the over-the-counter markets?

COUNTERSTATEMENT OF THE CASE

Hagen Investments, Inc. ("Hagen Investments"), formerly registered with the Securities and Exchange Commission as a broker and dealer in securities, and Edward J. Hagen ("Hagen"), Hagen Investments' president, [1/] have petitioned this Court, presumably pursuant to Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a), [2/] to

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1/ While the instant proceeding was pending before the Commission, petitioners consented to the entry of an order in another administrative proceeding, whereby Hagen Investments' registration as a broker and dealer in securities was revoked and Hagen was barred from being associated with any broker or dealer. That proceeding, brought pursuant to Sections 15(b)(5) and (7) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(5) and (7), was based on other allegations, which were not admitted by the petitioners herein, including charges of violations of antifraud provisions of the federal securities laws. See Hagen Investments, Inc., Securities Exchange Act Release No. 8859 (April 3, 1970).

2/ Although petitioners fail to specify the statutory provision pursuant to which the instant petition for review is brought, we assume that Section 25(a) of the Securities Exchange Act--the sole judicial review provision contained in that Act--is the intended authority for this petition, inasmuch as the Commission's oversight of NASD activities arises solely by virtue of Section 15A of the Securities Exchange Act, 15 U.S.C. 78o-3.

review an order of the Securities and Exchange Commission, entered on September 7, 1971 (App. 1-8).[3] The order appealed from dismissed proceedings for review by the Commission of disciplinary action taken against the petitioners by the National Association of Securities Dealers, Inc. ("NASD"), a private nonprofit corporation, organized under the laws of Delaware and registered with the Commission as a national securities association, pursuant to Section 15A of the Securities Exchange Act, 15 U.S.C. 78o-3 (commonly known as, and sometimes hereafter referred to as, the "Maloney Act").

For purposes of this petition for review, petitioners concede (H Br. 3, 6) that they did not promptly and properly consummate authorized orders for the purchase and sale of certain securities and that they nevertheless continued to accept buy and sell orders as to those securities[4] --the conduct subsequently found by both the NASD (App. 9-10) and the Commission (App. 1-8) to have been in contravention of Article III, Section 1, of the NASD's Rules of Fair Practice. This provides:[5]

3/ References to the appendix filed by the petitioners in this action are cited as "App. ___." References to petitioners' brief are cited as "H Br. ___." References to the Record before the Commission are cited as "R. ___." The record will be lodged with the Clerk of the Court.

4/ In the proceedings before the Commission, before the NASD and before the latter's District Committee, petitioners had urged that their conduct did not in fact violate the emergency rules here under scrutiny (App. 3, 10, 13). Petitioners have not renewed this contention in this Court.

5/ CCH, NASD Manual ¶2151. Petitioners assert (H Br. 2), that "[t]he disciplinary action taken by the Association was based upon alleged violations of [NASD] Emergency Rule Nos. 68-4, 69-2, and 69-4 . . . ." In fact, the NASD's District Committee also found and the NASD affirmed (App. 9, 10) that petitioners' "conduct was inconsistent with just and equitable principles of trade and [thus] also violated Article III, Section 1 of the Association's Rules of Fair Practice."

> "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

Specifically, petitioners were found to have contravened the provision by violating the NASD's Emergency Rules of Fair Practice 68-4, 69-2 and 69-4. Petitioners' only argument in this Court is that the NASD lacked appropriate authority to proscribe, without full membership vote, the activities for which they were sanctioned.

1. The NASD

Although Congress in 1934 provided for self-regulation of national securities exchanges when it adopted the Securities Exchange Act, Congress did not at that time extend this concept of self-regulation to brokers and dealers who operated exclusively in the over-the-counter markets.[6/] It recognized that "effective regulation of the exchanges requires as a corollary a measure of control over the over-the-counter markets,"[7/] but initially it left to the Commission the job of policing

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6/ The over-the-counter markets have been described as follows:

> "Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. . . . [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience, and function; the securities differ in price, quality, and activity."

Securities and Exchange Commission, 2 Report of Special Study of Securities Markets 541 (1963) (hereinafter cited as "Special Study").

7/ H.R. Rep. No. 1383, 73d Cong., 2d Sess., 15-16 (1934). See also S. Rep. No. 792, 73d Cong., 2d Sess., 6 (1934).

those markets.[8] By 1938, however, Congress determined that qualified self-regulation of the over-the-counter markets was appropriate. In considering how the over-the-counter markets could most effectively be regulated, Congress stated three major objectives:

> "First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry; second, to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market; and, third, to afford to the investor an economic service the efficiency of which will be commensurate with its economic importance, so that the machinery of the nation's markets will operate to avoid the misdirection of the nation's savings, which contributes powerfully toward economic depressions and breeds distrust of our financial processes." [9]

To attain these objectives, Congress adopted the Maloney Act, the primary purpose of which was to "provide for the establishment of a mechanism of regulation among over-the-counter brokers and dealers operating in interstate and foreign commerce or through the mails, [and] to prevent acts and practices inconsistent with just and equitable principles of trade. . . ."[10] The mechanism chosen by Congress, as reflected in the Maloney Act, was "cooperative regulation, in which the task will be largely performed by representative

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8/ See S. Rep. No. 1455, 75th Cong., 3d Sess., 4 (1938). See also Westwood & Howard, Self-Government in the Securities Business, 17 Law & Contemp. Probs. 518, 526 (1952).

9/ S. Rep. No. 1455, 75th Cong., 3d Sess., 3 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess., 4 (1938).

10/ Act of June 25, 1938, C.677, 52 Stat. 1070.

organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation."[11/]

The Maloney Act provides that, subject to certain conditions, "[a]ny association of brokers or dealers may be registered with the Commission as a national securities association . . . ."[12/] As a matter of fact, the NASD is the only organization which has registered with the Commission. By its terms, the Act prohibits the Commission from registering an organization as a national securities association unless the association has adopted rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest . . . ."[13/] The Act also requires a registered national securities association to adopt rules which provide that members of the association shall"be

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11/ S. Rep. No. 1455, 75th Cong., 3d Sess., 4 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess., 4-5 (1938). See also, Don D. Anderson & Co., Inc. v. Securities and Exchange Commission, 423 F. 2d 813, 814 (C.A. 10, 1970); Handley Investment Co. v. Securities and Exchange Commission, 354 F. 2d 64, 65 (C.A. 10, 1965).

12/ Section 15A(a) of the Securities Exchange Act, 15 U.S.C. 78o-3(a).

13/ Securities Exchange Act Section 15A(b)(8), 15 U.S.C. 78o-3(b)(8). When the Commission allowed the NASD to register with it as a national securities association, it found that the NASD's rules satisfied all the requirements of Section 15A. National Association of Securities Dealers, Inc., 5 S.E.C. 627 (1939).

appropriately disciplined, by expulsion, suspension, fine, censure . . . or any other fitting penalty, for any violation of its rules."[14/]

The NASD's certificate of incorporation and by-laws reflect this Congressional directive. The third article in the NASD's certificate of incorporation states that one of the purposes to be carried out is to "adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors."[15/] Article VII, Section 1, of the NASD's by-laws[16/] authorizes its board of governors to adopt, from time to time for submission to the membership, rules of fair practice designed to "promote and enforce just and equitable principles of trade and business . . . [and] to maintain high standards of commercial honor and integrity among members . . . ." It is pursuant to this authority that the NASD adopted rules to the effect that its members must, in the conduct of their business,

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14/ Section 15A(b)(9) of the Act, 15 U.S.C. 78o-3(b)(9). In addition, the Commission is authorized to suspend, for a period not exceeding twelve months, or to revoke, the registration of a national securities association if it finds that such an association "has failed to enforce compliance with its own rules. . . ." Section 15A(l)(1), 15 U.S.C. 78o-3(l)(1).

15/ CCH, NASD Manual ¶1003.

16/ CCH, NASD Manual ¶1501; App. 32.

"observe high standards of commercial honor and just and equitable principles of trade."[17/]

Article VII, Section 1, of the NASD's by-laws also authorizes its board of governors,[18/] where that body "finds an emergency to exist,"[19/] to adopt, by two-thirds vote of the board, "rules of fair practice or amendments thereto, if . . . [the rules are] not disapproved by the Commission . . ., without submission [of the rules] to the members for a vote . . ." (emphasis supplied). As it existed during the time periods relevant here, this by-law provision also stated that "no such rule of fair practice or amendment shall be effective for more than sixty days or the duration of the emergency as declared by the Board of Governors, whichever is the less" (App. 32).[20/]

17/ CCH, NASD Manual ¶2151.

18/ Of the 27 members of the board of governors, the NASD's by-laws require that 21 be elected from various districts by the members in those districts (Art. IV, Section 2(a), CCH, NASD Manual ¶1402, Art. IV, Sections 3(a)-(e), CCH, NASD Manual ¶1403), 3 be elected by the board and designated governors-at-large (id., Section 3(h)), and the board elect 2 additional members, one each from among the mutual fund underwriter members and the insurance company or insurance company affiliated members (id., Sections 3(f), (g)). The board of governors also elects the president of the NASD who then becomes a member of the board. Article V, Section 2, of the NASD's by-laws, CCH, NASD Manual ¶1452.

19/ Where Rules of Fair Practice are to be submitted to the membership for a vote, they need only be adopted by a majority of a quorum of the board of governors. Art. IV. Section 8 of the NASD's by-laws, CCH, NASD Manual ¶1408.

20/ Subsequent to the occurrences here, the NASD membership approved a modification in this by-law provision which, among other things, extended the initial emergency period to 6 months (App. 33).

In addition to such rules governing the activities of members, the Maloney Act requires that the rules of a registered securities association "assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs."[21/]

In keeping with the principle of qualified or circumscribed self-regulation, Congress gave to the Commission the power, after appropriate notice and opportunity for hearing "to abrogate any rule of a registered securities association . . . if . . . it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of . . . [the Maloney Act]."[22/] The Commission also was given the authority to request a registered securities association to alter or supplement its rules with respect to, inter alia, the "method for adoption of any change in or addition to the rules of the association,"[23/] and "the method of choosing officers and directors."[24/] If the association fails to alter or supplement its rules in the

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21/ Section 15A(b)(6), 15 U.S.C. 78o-3(b)(6). Prior to the 1964 amendments to the Securities Exchange Act of 1934, Pub. L. No. 88-467, 78 Stat. 565, this subsection was numbered (5).

22/ Section 15A(k)(1), 15 U.S.C. 78o-3(k)(1). The Commission also has the authority to disapprove any proposed changes in or additions to existing rules. Section 15A(j), 15 U.S.C. 78o-3(j).

23/ Section 15A(k)(2)(B), 15 U.S.C. 78o-3(k)(2)(B).

24/ Section 15A(k)(2)(C), 15 U.S.C. 78o-3(k)(2)(C).

manner requested, the Commission is authorized to order such alteration or supplement if, "after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors . . . ."[25/]

2. The Operational and Financial Crisis Confronting the Securities Industry During the Period 1967-1970

As the Commission recently reported to Congress, in the years 1967-1970 occurred "the most prolonged and severe crisis in the securities industry in forty years." Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 1st Sess., 1 (1971) (hereinafter cited as "Unsafe and Unsound").[26/] The report continued:

> "Widespread failures of broker-dealer firms and concern for the funds of their customers had followed a prolonged period of easy business. . . . A veritable explosion in trading volume clogged an inadequate machinery for the control and delivery of securities. Failures to deliver

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25/ Section 15A(k)(2), 15 U.S.C. 78o-3(k)(2).

26/ For a detailed analysis of the operational problems confronting the securities industry during this period, see, Hearings on Financial and Operational Problems in the Securities Industry Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 1st Sess., pt. 2 (1971) (hereinafter "1971 Senate Hearings"); Hearings on the Study of the Securities Industry Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 1st Sess., pt. 1 (1971) (hereinafter "1971 House Hearings"); Hearings on Securities Markets Agencies Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 1st Sess. (1969) (hereinafter "Securities Markets Agencies Hearings"); Report on the Securities Industry Study of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. (Comm. Print, February 4, 1972) (hereinafter "1972 Senate Report"). See also, Review of SEC Records of the Demise of Selected Broker-Dealers; Staff Study for the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce, 92d Cong., 1st Sess. (Subcommittee Print, July 1969)(hereinafter "Staff Study"); H. Baruch, Wall Street: Security Risk (1971).

> securities and to make payment ricocheted through the industry and firms lost control of their records and of the securities in their possession or charged to them. Operational conditions deteriorated so severely that securities markets were required to cease trading one day each week at one point and later to limit daily trading hours.
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> * * *
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> "Firms and self-regulatory authorities were thrashing about in all directions fighting to avoid catastrophe. Time and time again they had to select the lesser evil. Decisions had to be made in a rapidly changing situation."

There had been a nearly 200 percent increase in average daily trading volume on the registered exchanges between 1963 and 1968.[27/] This unanticipated trading increase spilled over into the over-the-counter markets in roughly comparable percentages.[28/]

> "The result was chaos at some firms, and a loss of record keeping control. This, in turn, led to loss of physical control over certificates and their movement. And, most firms threw into the breach newly recruited and inadequately trained men who not only increased operational errors in geometrical proportion but also exposed the industry to a certain kind of risk not previously experienced in a substantial way--the risk of loss of control over securities." 29/

The "loss of control over [customers'] securities" became evident by the inability of brokers and dealers successfully to complete their

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27/ Staff Study, at p. 1.

28/ While precise volume figures for trading in the over-the-counter markets are not maintained, it is estimated that it equals the combined volume on the New York and American Stock Exchanges, the nation's two largest stock exchanges. Securities Markets Agencies Hearings, at p. 9.

29/ 1971 House Hearings, at p. 50 (Statement of Irving M. Pollack (Director) and Sheldon Rappaport (Associate Director, Regulation) of the Commission's Division of Trading and Markets).

customers' transactions, as indicated by the growing dollar amounts of "fails to deliver." A "fail to deliver" represents the obligation of a broker to deliver securities it has sold to another broker but which, for some reason, the selling broker is unable to deliver. As noted in the 1972 Senate Report (p. 10):

> "The increase in fails and related problems had important industry-wide effects upon the securities markets. Many investors became frustrated with the paperwork problems and resolved to avoid or reduce investments in securities. . . . Excessive fails to deliver have an unfavorable effect upon the broker-dealer's working capital . . . . A seller who has delivered his securities to his broker is entitled to payment by his broker on settlement date regardless of whether the broker has transmitted the securities to the buyer. Yet the broker is not reimbursed by the purchasing side until he delivers. Thus, in a fail situation, the seller's broker has often advanced funds to his customer which could otherwise be employed as working capital in the business" (emphasis in original, footnotes omitted). 30/

Throughout the period 1967-1970, the Commission and the self-regulatory authorities (the NASD and the stock exchanges) were

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30/ The 1972 Senate Report also pointed out (p. 10) that a broker-dealer's failure to deliver securities affects not only its own financial position but also that of the purchasing broker. This is because for every "fail to deliver" there must be a corresponding "fail to receive." The latter is carried on the books of the purchasing broker as a liability because, when and if the securities are finally delivered, it will have to pay the contract price to the selling broker. Since a "fail to receive" is a liability, for purposes of the Commission's net capital requirements--which prohibit a broker-dealer from incurring aggregate indebtedness which exceeds 2000 percent of the broker's net capital--it must be included among the broker's items of aggregate indebtedness and therefore must be supported by a firm's net capital. It has been noted:

> "Among broker-dealers of limited capital, this might . . . result in a limitation of their business activities . . . ."

1 Special Study, at p. 417.

"fighting to avoid catastrophe."[31] In 1967 through mid-1968, the actions taken by the Commission and self-regulatory authorities to cope with the back-office problems were "essentially of an emergency and short-term character."[32] These actions included the temporary curtailment of the trading hours in the securities markets to give back-office personnel an opportunity to process backlogs,[33] the imposition of mandatory reporting requirements with respect to outstanding fails,[34] the institution of an operation and back-office inquiry by the Commission[35] and an accelerated back-office inspection program by the self-regulatory authorities.[36] These actions, however, resulted in no appreciable diminution of the back-office problems primarily because trading volume continued to increase, thus generating even more paperwork. Because the paperwork crisis was getting worse rather than better, even more restrictive actions were taken. Thus, for example, in June 1968, the NASD adopted Emergency Rule 68-1, which, in effect, closed the over-the-counter

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31/ Unsafe and Unsound, at p. 1. For a chronology of the actions taken by the Commission during the period 1967-1971 see, id. at 226-237. For a summary of the actions taken by the NASD, see, Securities Markets Agencies Hearings at pp. 198-201, Exhibit 3 at 323-442. And for a summary of actions taken by the New York Stock Exchange, see, 1971 House Hearings at pp. 14-29, 30-32.

32/ Securities and Exchange Commission, Thirty-Fourth Annual Report 17 (1968).

33/ Id. at 16.

34/ See, e.g., Unsafe and Unsound, at pp. 226-227.

35/ Id. at p. 227.

36/ See, e.g., Securities Markets Agencies Hearings, at p. 199.

markets on Wednesdays,[37] and in late summer of 1968 the New York and American exchanges adopted a series of changes in their rules[38] which, inter alia, required mandatory buy-ins[39] to complete contracts which were not fulfilled for a period of 50 calendar days and prohibited members from executing customers' sell orders unless the member had reasonable assurances that the customer would promptly deliver the securities.[40] At the same time, the Commission cautioned broker-dealers that they must comply with applicable requirements regarding the maintenance of current books and records, financial responsibility and prompt delivery of securities and settlement of transactions.[41] The Commission also warned brokers and dealers that it is a violation of the antifraud provisions of the federal securities laws for a broker or dealer to accept or execute any order for the purchase or sale of any security if that broker-dealer does not have the personnel or facilities available promptly to execute and consummate all its transactions.[42]

37/ Id. at p. 387.

38/ See 1971 House Hearings at 17.

39/ Under the buy-in procedure, a broker which has not received the securities contracted for can go into the market to purchase those securities and charge the broker which failed to deliver the difference between the contract price and the purchase price.

40/ The NASD's board of governors interpreted Article III, Section 1, of the NASD's Rules of Fair Practice to impose a similar requirement. See CCH, NASD Manual ¶ 2151 at pp. 2036-2037.

41/ Securities Exchange Act Release No. 8335 (June 17, 1968).

42/ Securities Exchange Act Release No. 8363 (August 7, 1968).

By the end of 1968, these actions had not significantly alleviated the paperwork crisis or stemmed the loss of control over customers' securities. Volume continued to increase, and the dollar amount of "fails to deliver" of New York Stock Exchange members reached $4.1 billion,[43/] while the total dollar amount of "fails to deliver" of 70 selected NASD members was $585.2 million.[44/]

Because the situation with respect to fails grew worse, the NASD, at the Commission's urging,[45/] adopted Emergency Rules 68-4, 69-2 and 69-4 (App. 21-29, 30-31), which delineated restrictions on a member's ability to accept buy orders or to sell for his own account in those securities in which the broker had "aged" fails. The first of these became effective December 2, 1968, the second on January 31, 1969, and the third on February 15, 1969.

Rules 68-4 and 69-2 prohibited, inter alia, the acceptance of customer purchase orders by brokers in particular securities, if the broker had

> "a fail to deliver in that security 60 days old or older, and, any one of the following conditions exists:
>
> "(1) his total dollar volume of fails to deliver over 30 days are 30% or more of his total dollar volume of fails to deliver; or

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43/ Securities and Exchange Commission, Thirty-Fifth Annual Report 2 (1969). 1971 House Hearings at p. 47 (statement of Irving M. Pollack).

44/ 1971 House Hearings, at p. 43. This figure is based on the fails reports of 70 NASD members who were not also members of the New York or American exchanges. In fiscal year 1969 (July 1, 1968 - June 30, 1969), there were 4,102 members of the NASD. Securities and Exchange Commission, Thirty-Fifth Annual Report 104 (1969). Many, however, were also members of some exchange so that their fail figures probably would be included in the exchanges' statistics rather than the NASD's.

45/ Unsafe and Unsound, at p. 229, 230.

> "(2) his total dollar volume of fails to deliver over 30 days in that security are 7% or more of his total dollar volume of fails to deliver over 30 days; or
>
> "(3) he has any fail to deliver in that security 120 days old or older" (App. 23, emphasis in original).

These rules also required members to review their fail positions once a month. Where, upon such a monthly review, a member discovered any fail to deliver or fail to receive 120 days old or older, the rules required that the appropriate District Committee be apprised, within 10 days of the end of such a month, of the details and any efforts undertaken to effect delivery (App. 23, 27). Finally, these rules provided that "[f]or good cause shown and in exceptional circumstances . . ." a member could request exemption from the rule where the member could demonstrate, among other things, that "application of the rule would work hardship upon public customers and/or the member . . . ." (App. 23,27.)

Emergency Rule 69-4 required members to clear fails before they were 150 days old, whether or not the broker accepted orders for transactions in that security (App. 31). Failure to comply with this requirement was stated to constitute a per se violation of Article III, Section 1 (App. 31).

By the end of the first half of 1969, the total amount of fails to deliver had declined to approximately $2.2 billion.[46/] This reduction apparently resulted from decreased market volume.[47/]

46/ Securities and Exchange Commission, Thirty-Fifth Annual Report 2 (1969).

47/ Trading volume once again increased in the latter part of 1970 and the number of fails increased at least in proportion to the trading volume increase and possibly more so because of reductions in back-office personnel during the financial crisis precipitated by the market decline in 1969-1970. Staff Study, at p. 2.

But the decline in trading volume in 1969 did not serve to dissipate the consequences generated by the still excessive "fails" position of many brokers:

> "Fails combined to create nightmares for the broker-dealer. Consider, for example, the customer who purchased securities which the seller failed to deliver and then, before receipt of the securities, decided to sell. His broker would then be obligated to deliver out securities which it did not possess and to pay its customer amounts for which it has not been reimbursed and had no immediate prospect of being reimbursed until it could itself receive delivery and redeliver to the buying broker. Such situations snowballed during periods of high volume causing some firms to lose the ability to maintain current and accurate books and records which they were obligated by law to maintain.
>
> "The cumulative effect of clearance and settlement problems was that in 1969 what had been a paperwork crisis became a contributing factor in the severe financial problems which faced the securities industry." 48/

In 1970, Congress enacted the Securities Investor Protection Act 49/ to provide some form of permanent protection to customers of brokerage firms which become insolvent as a result of the 1969-1970 crisis. In discussing the need for such legislation, the Senate Committee on Banking and Currency noted that the existence of "fails" had contributed to the demise of many brokerage firms over the immediately preceding four-year period. 50/

48/ 1972 Senate Report at 10 (footnotes omitted).

49/ 15 U.S.C. 78aaa, et seq.

50/ S. Rep. No. 91-1218, 91st Cong., 2d Sess., 2-3 (1970).

3. The Proceedings Against Hagen Investments and Hagen

As noted above (pp. 15-16, supra), in the midst of the 1967-1970 financial and operational crisis the NASD employed its emergency powers to adopt "interim measure[s], to assist in alleviating . . ." the problems generated (App. 22). Pursuant to Rule 68-4, petitioners in January 1969 began filing monthly statements with the regional NASD District Committee, for the purpose of apprising the Committee of their monthly fail situation (App. 11, 18, R. 63-64). Thereafter, and as a direct result also of a special examination of Hagen Investments conducted by the NASD in February 1969 (App. 11), a complaint against petitioners was filed by the NASD District Business Conduct Committee for District No. 4, charging that petitioners had failed to "observe high standards of commercial honor and just and equitable principles of trade," as required by Article III, Section 1, of the NASD's Rules of Fair Practice (1) by repeatedly soliciting and entering "into . . . transactions of sale for firm account and/or purchases for the account of customers in eleven different securities . . ." at a time when the firm carried fails to deliver in those securities in excess of 120 days old (App. 13)--conduct proscribed by Emergency Rules 68-4 and 69-2--and (2) by repeatedly failing to clear or settle fail items which were at least 150 days old (App. 13)--conduct proscribed by Emergency Rule 69-4.

After an evidentiary hearing, the District Committee found that petitioners had repeatedly violated each of these emergency rules (App.

16, 19). Petitioners thereupon challenged the NASD board of governors' authority to promulgate such rules (App. 14) and also challenged the District Committee's allegation that many of the aged and uncleared items actually were "fails" (App. 15). Both challenges were considered and rejected by the District Committee, which imposed upon respondents, jointly and severally, a fine of $5,000 and assessed costs in the amount of $278.25 (App. 20). The board of governors of the NASD, in a decision dated August 31, 1970, affirmed the District Committee's findings with respect to the violations and the validity of the Emergency Rules. It considered the sanctions imposed by the District Committee to be inadequate, however, in light of the "extremely serious" nature of the violations (App. 10). The board of governors therefore increased the sanction imposed upon petitioners to include a censure, a suspension of Hagen Investments, Inc. from the NASD for three days and a suspension of Edward J. Hagen from associating with any member of the NASD for three days. In light of its imposition of a suspension upon petitioners, the board of governors reduced the fine imposed by the District Committee from $5,000 to $3,000 and imposed additional costs of $15.00, the costs of the appeal to the Board of Governors (App. 10).

Upon review of the NASD's findings and order, the Commission found that on 77 separate occasions the petitioners had solicited and entered into transactions in various securities when the firm carried fails to deliver in those securities in excess of 120 days old (App. 6),[51/] and that, in 64 separate instances, the

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51/ Of these 77 violations of Emergency Rules 68-4 and 69-2, 70 occurred between December 2, 1968, and January 30, 1969, the effective period of the first emergency rule, Rule 68-4 (R. 325-337).

petitioners had not cleared or settled fails which were 150 days old (App. 7). All of the violations were found to have occurred during the period December 1968 through February 1969, at the peak of the increased volume which generated so many of the industry's problems (see pp. 12-16, supra).

The Commission rejected petitioners' arguments that the NASD's Emergency Rules were not validly enacted and that in any event no emergency existed, stating:

> "Under the circumstances presented here . . . we do not believe that it was improper for the NASD to deal through its emergency rule procedures with the back office situation that it initially found to exist in June 1968. We also consider that the need for flexibility of action justified the NASD in determining periodically thereafter, at least until it could be ascertained what the conditions that existed required on a long term basis, whether extraordinary restrictions on members' activities were still needed rather than undertaking to incorporate such restrictions into its permanent rule structure . . . .
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> * * *
>
> We cannot say that the NASD was not justified in its determinations incident to the enactment of the rules here under consideration that the emergency originally found to exist still persisted" (App. 4).

In response to petitioners' argument that the NASD's by-laws, which limited the effectiveness of an emergency rule to "60 days or the duration of the emergency as declared by the Board of Governors, whichever is less" (App. 32), rendered the emergency rules in issue invalid, the Commission stated:

> "we [do not] read the by-law provision under which the Board acted as limiting the duration of an emergency to a maximum of 60 days. In our view, that provision merely represented a limitation on the life of the particular rule, and did not preclude the NASD from re-enacting the same rule for another 60 day period, or adopting a new rule

> designed to cope with the same emergency, provided only that it made a new determination that the emergency conditions still existed" (App. 4).

The Commission upheld the sanctions imposed by the NASD[52/] and dismissed the proceedings for review (App. 8).[53/] Petitioners have not applied for a stay of the Commission's order.

STATUTES AND RULES INVOLVED

Sections 15A and 25(a) of the Securities Exchange Act are relevant to this proceeding and are set forth in the statutory appendix at the conclusion of this brief, pp. 1a, et seq., infra. Article VII, Section 1, of the NASD's By-Laws is set forth in the record appendix filed by petitioners (App. 32-33), as are NASD Emergency Rules 68-4 (App. 23), 69-2 (App. 26) and 69-4 (App. 31). Article III, Section 1, of the NASD's Rules of Fair Practice is set forth in the statutory appendix to this brief at p. 8a, infra.

52/ In its opinion, the Commission noted (App. 7) that the sanctions imposed by the NASD's Board of Governors were rendered less severe than those imposed by the District Committee in light of the fact that the Commission, during the pendency of this proceeding, had entered an order in an unrelated case revoking the broker-dealer registration of Hagen Investments, Inc. and barring Edward J. Hagen from associating with any broker or dealer. See n.1, supra.

53/ Petitioners, in their brief (H Br. 2) and in their petition for review before this Court, characterize the Commission's action as a dismissal of their request for review of the NASD's disciplinary action and, in their petition for review, urge this Court to order the Commission "to review such [NASD] disciplinary proceedings." Section 15A(h)(1) of the Securities Exchange Act, 15 U.S.C. 78o-3(h)(1), requires the Commission, in reviewing NASD disciplinary proceedings, to consider all the evidence in the matter and conduct a full-scale adjudicatory proceeding to determine the propriety of the NASD's action. When the Commission finds the NASD's action to have been supported by "the record before the association and such other evidence as it [the Commission] may deem relevant . . .," the statute requires the Commission "by order [to] dismiss the proceeding . . ." (emphasis supplied).

ARGUMENT

Petitioners, who are not contesting the Commission's finding that they failed to conform to the NASD's Rules of Fair Practice by 141 separate violations of its emergency rules, urge this Court to reverse the $3,000 sanction imposed by the NASD and affirmed by the Commission on the ground either (a) that the NASD was without power to adopt the specific emergency rules involved because the emergency had been found to exist by the board of governors more than 60 days prior to the violations found or (b) that seven of the 141 violations occurred during a period when one of the emergency rules had been reenacted. Petitioners contend that no other result may flow from the proviso to the authorization in the NASD's by-laws for adoption of emergency rules by its board of governors without submission to the membership of the NASD. That authorization is as follows:

> "In any case, however, where the Board of Governors finds an emergency to exist, such rules of fair practice or amendments thereto, if adopted by a two-thirds vote of the Board of Governors and not disapproved by the Commission pursuant to Section 15A of the Act, may become effective as of such time as the Board of Governors may prescribe, without submission to the members for a vote as hereinbefore required; provided, however, that no such rule of fair practice or amendment shall be effective for more than sixty days or the duration of the emergency as declared by the Board of Governors, whichever is the less." 54/

54/ See Article VII of the NASD's by-laws, set forth at App. 32.

Contrary to petitioners' assertions, we show below that their restrictive interpretation of this authorization is required neither by the "enabling statute" (H Br. 8)[55/] nor by the "plain language" (H Br. 13) of the by-law provision quoted above.

A. The Maloney Act Delegated Broad Powers to the NASD to Enable It to Ensure the Protection of Public Investors and Nothing in that Act or Its Legislative History Suggests that the NASD's Board of Governors is Powerless to Implement, without Membership Vote, Temporary Solutions to Continuing Emergency Situations Threatening the Interests of Public Investors.

The Maloney Act was seen as "imperative to prevent the evasion of the system of regulation of exchange trading embodied in the Securities Exchange Act of 1934 . . . by the withdrawal of securities from listing on exchanges, and by transferring trading therein to 'over-the-counter' markets where manipulative evils could continue to flourish . . . ."[56/] But Congress explicitly rejected the concept of leaving such regulation solely in the hands of this Commission, for it recognized the limitations of direct governmental regulation engendered by limited staff, limited funds and, perhaps most importantly,

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55/ As the Supreme Court has noted with respect to the Securities Exchange Act, "remedial legislation should be construed broadly to effectuate its purposes." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Cf. Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

56/ H.R. Rep. No. 2307, 75th Cong., 3d Sess., 3 (1938).

the difficulties inherent in the government's attempt to define ethical and moral, as opposed solely to legal, standards of conduct.[57/]

Petitioners place primary reliance (H Br. 1, 8-12) upon Section 15A(b)(6) of the Securities Exchange Act which requires the NASD, inter alia, to "assure a fair representation in the adoption of any rule of the association or amendment thereto . . . ." They argue that their right to vote on the emergency rules here involved stems from this statutory provision. Apart from the fact that the statute cannot be deemed to contemplate any circumstances under which the membership of the NASD may abrogate basic standards of conduct established by the Securities Exchange Act, see pp. 28-31, infra, there is no reason to assume that the "fair representation" standard meant a direct vote by the NASD membership on all phases of its operations. Rather, Congress explicitly stated that the statutory language meant "reasonable representation . . . ."[58/] The legislative history of the Maloney Act, including that cited by petitioners (H Br. 8-12), indicates

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57/ Id. at 2-4. As stated by Mr. Justice Stewart, dissenting in Silver v. New York Stock Exchange, 373 U.S. 341, 371 (1963):

> "The purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions . . . [stock exchanges and national securities associations] . . . which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry."

58/ S. Rep. No. 1455, 75th Cong., 3d Sess., 7 (1938). H.R. Rep. No. 2307, 75th Cong., 3d Sess., 7 (1938).

that Congress' concern was that the individual brokers and dealers, who became members of a registered securities association because of economic necessity,[59] would have some protection against the domination of such an association by a limited segment of the membership.[60] Congress left to the Commission the responsibility to assure that each member of a registered securities association had equal rights.[61] The right of members to vote for governors

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59/ Strictly speaking, membership in the NASD is voluntary. As a practical matter, however, a broker or dealer who is not a member is excluded from a sizeable segment of the securities business, since under the Maloney Act the NASD is given the power to adopt rules which would prohibit members from dealing with nonmembers except on the same terms and conditions as the member affords the general public. Section 15A(i)(1), 15 U.S.C. 78o-3(i)(1). Without the dealer's concession, a broker or dealer is effectively excluded from the over-the-counter market, at least insofar as he must deal with NASD members. See, National Association of Securities Dealers, 19 S.E.C. 424, 441 (1945); 4 Special Study, at 605. This is in accord with the legislative purpose. The House Interstate and Foreign Commerce Committee stated that

> "it is contemplated that exclusion from membership in a registered securities association will be attended and implemented by economic sanctions. In this respect, exclusion from such an association would be comparable in effect to expulsion from a national securities exchange. It is these economic sanctions which would make possible effective disipline within the association."

H.R. Rep. No. 2307, 75th Cong., 3d Sess., 9 (1938).

60/ Hearings on S. 3255 Before the Senate Comm. on Banking and Currency, 75th Cong., 3d Sess., 22 (1938) (statement of Commissioner Mathews). See also, Hearings on S. 3255 and H.R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 75th Cong., 3d Sess., 15 (1938) (statement of Commissioner Mathews).

61/ Id. at 15 (statement of Rep. Boren).

of the NASD, selected in the manner set forth in note 18, supra, has been found by the Commission to satisfy the test of "reasonable" or "fair" representation with respect to the adoption of emergency rules.[62] Any right of the petitioners to vote directly on the adoption of emergency rules, therefore, must derive from the NASD's by-laws rather than the Maloney Act.[63]

62/ The Commission has viewed the test of "fair representation" as requiring that factors such as geography, size of firm and type of business be considered. 4 Special Study, p. 608. Since the NASD's rules were approved by the Commission in 1939, National Association of Securities Dealers, Inc., 5 S.E.C. 627 (1939), the NASD's board of governors always has had the power, with Commission concurrence, to adopt emergency rules by a two-thirds vote. And the Commission had early taken the view that the right of NASD members to vote for rules is derived from the NASD's By-Laws. See National Association of Securities Dealers, Inc., 17 S.E.C. 459, 461 (1944). This settled and contemporaneous administrative interpretation is entitled to deference. See Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294 (1933); Udall v. Tallman, 380 U.S. 1 (1965).

As the Supreme Court reiterated in Udall, 380 U.S. at 16 (citations omitted):

> "'To sustain the Commission's application of this statutory term, we need not find that its construction is the only reasonable one, or even that it is the result we would have reached had the question arisen in the first instance in judicial proceedings.' . . . 'Particularly is this respect due when the administrative practice at stake "involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new."'"

63/ Petitioners seemingly concede (H Br. 13 n. 6) that the derivation of a right to vote on emergency rules stems, if at all, from the NASD's By-Laws by their apparent acknowledgment that the recent revision effected in the NASD's By-Laws (to permit two-thirds of the Board of Governors to adopt emergency rules for longer periods than 60 days, without membership vote), would alter their arguments.

B. The Provision for Emergency Rules in the NASD's By-Laws Is to Permit the Board of Governors to Take Effective Temporary Steps to Alleviate Emergency Conditions and Not to Limit the Board's Action for a 60-Day Period after Finding the Existence of an Emergency

The proviso to the authorization to the NASD's board of governors to adopt emergency rules of fair practice and amendments thereto (set forth in the quotation on p. 22, supra), we submit, evidences no more than the requirements that (1) emergency rules are in no event to be effective beyond the duration of the emergency and (2) the board of governors must redetermine within each 60-day period during an emergency whether a previously-adopted emergency rule is to continue unchanged or be amended or, perhaps, be superseded by a different emergency rule. This reading of the proviso is as much in accord with its "plain language" (H Br. 13) as is petitioners', and permits the NASD more responsively to fulfill its obligations to protect the public interest.

To hold, as petitioners urge, that the NASD was not entitled to adopt emergency rules where emergency conditions had persisted beyond 60 days would seem to place a premium upon precipitous decision-making and encumber that body's efforts rationally to sift out, experiment with and refine various measures that might resolve or alleviate the existing problem. 64/ And should the NASD, under constraint of

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64/ Cf. Delta Air Lines, Inc. v. Civil Aeronautics Board, ___ F. 2d ___ (C.A. D.C., 1971) (No. 71-1515). Slip op. at p. 8.

petitioners' theory, be compelled to submit interim rules designed to alleviate an emergency condition of uncertain duration to a full membership vote, it could run the risk of delaying, for a minimum of 30 days, 65/ the implementation of needed restrictions on membership activities believed to be inimical to the interests of public investors.

C. Petitioners' Interpretations of the Maloney Act and of the Provision of the NASD's By-Laws Authorizing Emergency Rules Incorrectly Assume that the NASD Membership Can Repeal Protective Provisions of the Securities Exchange Act and Just and Equitable Principles of Trade

The NASD, as we have seen (pp. 4-10, 23-24), is required by law to enforce the concept of "just and equitable principles of trade."

Whether or not the board of governors adopted the emergency rules in question, the conduct of the petitioners involved here was subject to the imposition of sanctions by the NASD as violative of "high standards of commercial honor and just and equitable principles of trade" in contravention of Article III, Section 1, of the NASD's Rules of Fair Practice. Thus, on August 1, 1968, more than three months prior to the effective date of Emergency Rule 68-4--the earliest of the challenged rules--the NASD notified its members that it intended to institute

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65/ The NASD membership has 30 days in which to cast votes upon the adoption of a rule by the board of governors. Art. VII, Section 1, of the NASD's by-laws (App. 33). Pursuant to Section 15A(j) of the Securities Exchange Act, 15 U.S.C. 78o-3(j), the NASD also is required to submit a copy of any proposed rules to the Commission and such rules become effective, unless disapproved by the Commission, 30 days after filing or upon such earlier date as the Commission determines. The Commission normally will make emergency rules effective prior to the expiration of 30 days.

disciplinary proceedings under Article III, Section 1, of its Rules of Fair Practice against any member "that has an unreasonable fail position, cannot promptly deliver securities to customers and/or cannot maintain the firm's books and records in strict compliance with the SEC books and records rule." 66/ The NASD based this interpretation of Article III, Section 1, on its view that "it is inherently improper and a violation of Section 1 for a member to sell securities to a customer when he has reason to believe he will not be able to deliver them to the customer promptly, or to have inadequate personnel or facilities to properly process, execute and consummate all of his securities transactions." 67/ Accordingly, prior to the adoption of the emergency rules here challenged the NASD had brought disciplinary cases against member firms for the types of violations for which petitioners were sanctioned. 68/ This was consistent with many other instances wherein the NASD has proceeded against members for conduct alleged to be inherently inconsistent with just and equitable principles of trade notwithstanding the absence of a specific rule defining the proscribed conduct; NASD findings of a violation of Article III, Section 1, in such circumstances

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66/ Securities Markets Agencies Hearings at p. 380.

67/ Ibid. Specifically, the NASD indicated that any member that engaged in business at the same time it had, inter alia, a significant number of outstanding fails on its books, a high fail position in one or more specific securities, or a preponderance of fails in excess of 30 days old, would be the subject of such disciplinary action.

68/ Id. at 381.

have been sustained by the Commission, which in turn has been sustained by the courts. 69/

Here, the purposes of the challenged emergency rules were (1) to deter members from entering into transactions where there was doubt that the transactions could be completed; and (2) to induce members to settle or otherwise clear aged fail-to-deliver items. Except for setting down definite guidelines for the benefit of members, these emergency rules established no new standards of conduct. Emergency Rules 68-4 and 69-2 in effect codified the NASD's prior interpretation that conduct inconsistent with those rules would be considered a violation of Article III, Section 1 (App. 24, 28). And Emergency Rule 69-4 stated that conduct inconsistent with that rule would be considered a per se violation of Article III, Section 1, and of that rule as well (App. 31).

Moreover, the concept of "just and equitable principles of trade" which the NASD is statutorily mandated to enforce, encompasses at least the legal standards of the Securities Exchange Act. 70/

69/ See e.g., Benjamin Werner d/b/a Benjamin Werner & Co., Securities Exchange Act Release No. 9242 (July 19, 1971), aff'd per curiam without opinion sub nom. Benjamin Werner d/b/a Benjamin Werner & Co. v. Securities and Exchange Commission, No. 71-1591 (C.A. D.C., Jan. 24, 1972); Handley Investment Co. v. Securities and Exchange Commission, 354 F. 2d 64 (C.A. 10, 1965); Nassau Securities Service v. Securities and Exchange Commission, 348 F. 2d 133 (C.A. 2, 1965); Samuel B. Franklin & Co. v. Securities and Exchange Commission, 290 F. 2d 719 (C.A. 9), certiorari denied, 368 U.S. 889 (1961).

70/ See Don D. Anderson & Co., Inc. v. Securities and Exchange Commission, 423 F. 2d 813 (C.A. 10, 1970); Barraco & Co., Securities Exchange Act Release No. 9149 (April 16, 1971); Valley Forge Securities Co., Inc., 41 S.E.C. 486, 488 (1963); Joseph Blumenthal, 41 S.E.C. 133, 136 (1962); cf. Bennett-Manning Co., 40 S.E.C. 879, 882 (1961).

Three months prior to the NASD's adoption of these emergency rules, the Commission had warned brokers and dealers that a broker or dealer who engages in securities transactions, when he has reason to believe that he will be unable promptly to consummate those transactions, violates the antifraud provisions of the federal securities laws.[71/] Here petitioners' conduct--repeatedly and flagrantly disregarding their fails position when accepting orders or entering into securities transactions--would seem to fall squarely within the conduct proscribed by the federal securities laws' antifraud provisions. Accordingly, whether or not the NASD membership had voted on and rejected these rules, petitioners' conduct still would have been in violation of the antifraud provisions of the Securities Exchange Act as well as of the standards of Article III, Section 1, of the NASD's Rules of Fair Practice.

Under these circumstances the Maloney Act cannot meaningfully be read as requiring the membership to vote on rules of the sort here involved and it would be pointless for the NASD by-laws to be read as imposing such a requirement.

71/ Securities Exchange Act Release No. 8363 (August 7, 1968). This view is based on the long-standing principle that a broker holds himself out as a professional, ready and able properly to serve the investing public. A broker violates the antifraud rules if he is unable to comport with that implicit representation. See, e.g., Hanly v. Securities and Exchange Commission, 415 F. 2d 589 (C.A. 2, 1969); Norris & Hirshberg, Inc., 21 S.E.C. 865, affirmed, 177 F. 2d 228 (C.A. D.C., 1949); Charles Hughes & Co., Inc., v. Securities and Exchange Commission, 139 F. 2d 434 (C.A. 2), certiorari denied, 321 U.S. 786 (1943); Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949); Duker & Duker, 6 S.E.C. 386 (1939). Accord, G. Alex Hope, 7 S.E.C. 1082 (1940); Allender Co., Inc., 9 S.E.C. 1043 (1941); Jack Goldberg, 10 S.E.C. 975 (1942); William J. Stelmack Corp., 11 S.E.C. 601 (1942); J. Logan & Co., 41 S.E.C. 88 (1962).

D. The Commission's Finding that the NASD's Fails Rules Were Adopted in the Face of a Continuing Emergency Is Supported by Substantial Evidence

Whether or not an emergency exists is basically a question of fact. Section 25(a) of the Securities Exchange Act provides that "the findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." Accord, 5 U.S.C. 706(2)(E). The courts have consistently held that an administrative agency's findings of fact are presumed to be supported by substantial evidence, and that a petitioner who challenges them must specifically designate those findings for which he claims that there is no substantial evidence.[72/] A reviewing court's function is not to determine where the weight of the evidence lies but, rather, is to determine whether there was, in fact, substantial evidence to support the Commission's findings. Consolo v. Federal Maritime Commission, 383 U.S. 607, 618-621 (1966).[73/]

72/ E.g., Keele Hair & Scalp Specialists, Inc. v. Federal Trade Commission, 275 F. 2d 18, 21 (C.A. 5, 1960); Steelco Stainless Steel, Inc. v. Federal Trade Commission, 187 F. 2d 693, 694-695 (C.A. 7, 1951).

73/ Accord, e.g., Pierce v. Securities and Exchange Commission, 239 F. 2d 160, 162 (C.A. 9, 1956).

The Commission's conclusion that an emergency did exist was predicated in large part on matters of official and public record of which the Commission appropriately took "official notice." See e.g., United States v. Pierce Auto Freight Lines, Inc., 327 U.S. 515, 529-530 (1946); Market Street Ry. Co. v. Commission, 324 U.S. 548, 561-562 (1945). Report of the Attorney General's Committee on Administrative Procedure, Administrative Procedure in Government Agencies, S. Doc. No. 8, 77th Cong., 1st Sess., 72 (1941). Petitioners did not request an opportunity to rebut any of these matters by way of rehearing or otherwise, cf. Attorney General's Manual on the Administrative Procedure Act 80 n. 5 (1947); Market Street Ry. Co. v. Commission, supra. 324 U.S. at 561-562; Section 7(d) of the Administrative Procedure Act, now codified as 5 U.S.C. 556(e) and we do not understand them to challenge the Commission's reliance upon these matters before this Court.

Petitioners do not contest that, as found by the Commission (App. 4), from June 1968 through February 1969, the period of petitioners' repeated violations, 74/ the back-office problems of brokers and dealers reached "alarming proportions . . . ." Nor can petitioners challenge the fact that these back-office problems, generated by unexpected trading volume and compounded by the fails situation, resulted in the demise or liquidation of approximately 110 brokerage firms and engendered drastic upheavals in the securities industry. 75/ Instead, petitioners argue that even if an emergency condition within the meaning of Article VII, Section 1, of the NASD's by-laws did exist in June 1968, when the board of governors first adopted an emergency rule designed to deal with the "back-office" problem (of which members' "fails" were but a part), this condition became more or less permanent by December 1968, thereby invalidating the board's adoption of the emergency rules dealing specifically with members' "fails." But as we have seen (pp. 10-17, supra), the situation during the period involved did not remain stable, and continuous emergency action was required.

In affirming the NASD's authority to adopt the emergency rules in question under the circumstances faced by the securities industry, the

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74/ Whether or not the emergency conditions originally cited by the NASD have persisted for three years as petitioners state (H Br. 19), we submit that the only relevant question here is whether an emergency continued to exist at the time the emergency rules under challenge were enacted and petitioners' violations occurred--nine months after the original declaration of an emergency.

75/ Staff Study at p. 7.

Commission cautioned (App. 3) that it would not permit unjustified resort to emergency rules by the NASD, in contravention of its by-laws, as a means of solving industry problems. But the Commission held that the NASD properly could continue to alleviate emergency conditions by the use of emergency rules "at least until it could be ascertained what the conditions that existed required on a long-range basis . . ." (App. 4). The securities industry today is in great upheaval. Legislative and regulatory efforts to control occurrences such as those involved here and to revamp the structure of the securities markets presently are in formulation but are by no means complete.[76/] At present, the NASD has begun implementation of a national clearing facility which may provide one permanent solution to the "fails" problem[77/] and obviate the need for emergency rules. It is the Commission's judgment that the adoption of the emergency rules here in issue not only was justified but was mandated by the circumstances,

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76/ See, e.g., Senate Resolution No. 109, 92d Cong., 1st Sess., 117 Cong. Rec., June 21, 1971, at S. 9506-9507; Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets, February 2, 1972, 137 BNA Securities Regulation & Law Report, pt. II, February 2, 1972 (Special Report).

77/ For a discussion of the NASD's efforts in this respect see, 1971 Senate Hearings at 259-265 (statement of Mr. Gordon S. Macklin, President, NASD).

pending development of permanent solutions. As this Court has noted:

> "The evaluation of facts and the exercise of judgment for the protection of investors dealing in over-the-counter securities is a function assigned by Congress to the Commission rather than the courts and the exercise by the Commission of its discretionary powers will not be upset by the courts except for cogent reasons." 78/

CONCLUSION

For the foregoing reasons, the order of the Commission affirming the NASD's sanctions against petitioners should be affirmed.

Respectfully submitted,

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APRIL 1972

78/ Associated Securities Corp. v. Securities and Exchange Commission, 293 F. 2d 738, 741 (C.A. 10, 1961). Accord, Don D. Anderson & Co., Inc. v. Securities and Exchange Commission, supra, 423 F. 2d at 817.

STATUTORY APPENDIX

Section 15A of the Securities Exchange Act

SECTION 15A. (a) Any association of brokers or dealers may be registered with the Commission as a national securities association pursuant to subsection (b), or as an affiliated securities association pursuant to subsection (d), under the terms and conditions hereinafter provided in this section, by filing with the Commission a registration statement in such form as the Commission may prescribe, setting forth the information, and accompanied by the documents, below specified:

(1) Such data as to its organization, membership, and rules of procedure, and such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors; and

(2) Copies of its constitution, charter, or articles of incorporation or association, with all amendments thereto, and of its existing bylaws, and of any rules or instruments corresponding to the foregoing, whatever the name, hereinafter in this title collectively referred to as the "rules of the association."

Such registration shall not be construed as a waiver by such association or any member thereof of any constitutional right or of any right to contest the validity of any rule or regulation of the Commission under this title.

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

(1) by reason of the number of its members, the scope of their transactions, and the geographical distribution of its members such association will be able to comply with the provisions of this title and the rules and regulations thereunder and to carry out the purposes of this section.

(2) such association is so organized and is of such a character as to be able to comply with the provisions of this title and the rules and regulations thereunder, and to carry out the purposes of this section.

(3) the rules of the association provide that any broker or dealer who makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraph (4) or (5) of this subsection, or a rule of the association permitted under this paragraph. The rules of the association may restrict membership in such association on such specified geographical basis, or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section. Rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if—

(A) such broker or dealer, whether prior or subsequent to becoming such, or

(B) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated,

has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange.

(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if such broker or dealer—

(A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with all members of such association or from being associated with all brokers or dealers which are members of such exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which consti-

tutes conduct inconsistent with just and equitable principles of trade.

(B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months, or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer.

(C) whether prior or subsequent to becoming a broker or dealer, by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer, and in entering such a suspension, expulsion, or order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof.

(D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person who, if such person were a broker or dealer, would be ineligible for admission to or continuance in membership under clause (A), (B), or (C) of this paragraph.

(5) the rules of the assocation provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. For the purpose of defining such standards and the application thereof, such rules may—

(A) appropriately classify prospective members (taking into account relevant matters, including type of business done and nature of securities sold) and persons proposed to be associated with members.

(B) specify that all or any portion of such standards shall be applicable to any such class.

(C) require persons in any such class to pass examinations prescribed in accordance with such rules.

(D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate.

(E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, and other qualifications (including, in the case of an applicant for membership, financial responsibility) of the applicant and that the association may adopt procedures for verification of qualifications of the applicant.

(F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 32 of this title, be deemed an application required to be filed under this title).

(6) the rules of the association assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs.

(7) the rules of the association provide for the equitable allocation of dues among its members, to defray reasonable expenses of administration.

(8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public in-

terest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include—

(A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member or other person may be found to have omitted.

(B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation.

(C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade.

(D) a statement setting forth the penalty imposed.

In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based.

(11) the requirements of subsection (c), insofar as these may be applicable, are satisfied.

(12) the rules of the association include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

The provisions of this subsection, as in effect prior to the date of enactment of the Securities Acts Amendments of 1964, shall be applicable to the rules of any registered securities association which was registered on such date until July 1, 1964. After July 1, 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules thereof do not conform to the requirements of this subsection, as amended by section 7 of the Securities Acts Amendments of 1964, and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with such requirements.

(c) The Commission may permit or require the rules of an association applying for registration pursuant to subsection (b), to provide for the admission of an association registered as an affiliated securities association, pursuant to subsection (d), to participation in said applicant association as an affiliate thereof, under terms permitting such power and responsibilities to such affiliates, and under such other appropriate terms and conditions, as may be provided by the rules of said applicant association, if such rules appear to the

Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of this section. The duties and powers of the Commission with respect to any national securities association or any affiliated securities association shall in no way be limited by reason of any such affiliation.

(d) An applicant association shall not be registered as an affiliated securities association unless it appears to the Commission that—

(1) such association, notwithstanding that it does not satisfy the requirements set forth in paragraph (1) of subsection (b), will, forthwith upon the registration thereof, be admitted to affiliation with an association registered as a national securities association pursuant to said subsection (b), in the manner and under the terms and conditions provided by the rules of said national securities association in accordance with subsection (c); and

(2) such association and its rules satisfy the requirements set forth in paragraphs (2) to (10), inclusive, and paragraph (12), of subsection (b); except that in the case of any such association any restrictions upon membership therein of the type authorized by paragraph (3) of subsection (b) shall not be less stringent than in the case of the national securities association with which such association is to be affiliated.

(e) Upon the filing of an application for registration pursuant to subsection (b) or subsection (d), the Commission shall by order grant such registration if the requirements of this section are satisfied. If, after appropriate notice and opportunity for hearing, it appears to the Commission that any requirement of this section is not satisfied, the Commission shall by order deny such registration. If any association granted registration as an affiliated securities association pursuant to subsection (d) shall fail to be admitted promptly thereafter to affiliation with a registered national securities association, the Commission shall revoke the registration of such affiliated securities association.

(f) A registered securities association (whether national or affiliated) may, upon such reasonable notice as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing with the Commission a written notice of withdrawal in such form as the Commission may by rules and regulations prescribe. Upon the withdrawal of a national securities association from registration, the registration of any association affiliated therewith shall automatically terminate.

(g) If any registered securities association (whether national or affiliated) takes any disciplinary action against any member thereof or any person associated with such a member or denies admission to any broker or dealer seeking membership therein, or bars any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), unless the Commission otherwise orders after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).

(h) (1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant—

(A) finds that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and

(B) determines that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association,

the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by

any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A), or if the Commission determines that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

(3) In any proceeding to review the denial of membership in a registered securities association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, determines that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member.

(i) (1) The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(2) For the purposes of this subsection, the term "nonmember broker or dealer" shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, who is not a member of any registered securities association, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, or commercial bills.

(3) Nothing in this subsection shall be so construed or applied as to prevent any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms.

(j) Every registered securities association shall file with the Commision in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, copies of any changes in or additions to the rules of the association, and such other information and documents as the Commission may require to keep current or to supplement the registration statement and documents filed pursuant to subsection (a). Any change in or addition to the rules of a registered securities association shall take effect upon the thirtieth day after the filing of a copy thereof with the Commission, or upon such earlier date as the Commission may determine, unless the Commission shall enter an order disapproving such change or addition; and the Commission shall enter such an order unless such change or addition appears to the Commission to be consistent with the requirements of subsection (b) and subsection (d).

(k) (1) The Commission is authorized by order to abrogate any rule of a registered securities 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 by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this title.

(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it

deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to—

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof.

(B) the method for adoption of any change in or addition to the rules of the association.

(C) the method of choosing officers and directors.

(D) affiliation between registered securities associations.

(*l*) The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest or for the protection of investors or to carry out the purposes of this section—

(1) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to revoke the registration of a registered securities association, if the Commission finds that such association has violated any provision of this title or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this section.

(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person—

(A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder.

(B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation.

(3) after appropriate notice and opportunity for hearing, by order to remove from office any officer or director of a registered securities association who, the Commission finds, has willfully failed to enforce the rules of the association, or has willfully abused his authority.

(m) Nothing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security.

(n) 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, the provision of this section shall prevail.

Section 25(a) of the Securities Exchange Act

Court Review of Orders

SECTION 25. (a) Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such person is a party may obtain a review of such order in the Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, and enforce or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, and enforcing or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 346 and 347).

Article III, Section 1 of the NASD's Rules of Fair Practice

ARTICLE III

Rules of Fair Practice

Business Conduct of Members

Sec. 1. A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.