CULPABILITY PREDICATES FOR FEDERAL SECURITIES LAW SANCTIONS: THE PRESENT LAW AND THE PROPOSED FEDERAL SECURITIES CODE

JOHN P. JAMES*

Introduction

Violation of the federal securities laws[1] may result in civil liability,[2] administrative sanction[3] by the Securities and Exchange Commission (the Commission), or criminal conviction. The administrative sanctions which may be imposed upon participants in the securities industry[4] are varied. Investment advisers[5] and

*Member of the Minnesota Bar. B.B.A., 1968, University of Iowa; J.D., 1974, Harvard University.

1 Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as Securities Act or Sec. Act]; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1970) [hereinafter cited as Exchange Act or Sec. Ex. Act]; Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1970) [hereinafter cited as Holding Company Act or Hold. Co. Act]; Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1970) [hereinafter cited as Trust Indenture Act or Trust Ind. Act]; Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1970) [hereinafter cited as Investment Company Act or Inv. Co. Act]; Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1970) [hereinafter cited as Investment Advisers Act or Inv. Adv. Act].

2 Sec. Act §§ 11, 12 & 15, 15 U.S.C. §§ 77k, 77*l* & 77o (1970); Sec. Ex. Act §§ 9(e), 16(b), 18, 20(a) & 29(b), 15 U.S.C. §§ 78i(e), 78p(b), 78r, 78t(a) & 78cc(b) (1970); Hold. Co. Act §§ 16(a), 17(b) & 26(b), 15 U.S.C. §§ 79p(a), 79q(b) & 79z(b) (1970); Trust Ind. Act § 323(a), 15 U.S.C. § 77wwww(a) (1970); Inv. Co. Act §§ 30(f) & 47(b), 15 U.S.C. §§ 80a-29(f), 80a-46(b) (1970); Inv. Adv. Act § 215(b), 15 U.S.C. § 80b-15(b) (1970). *See generally* 3 L. LOSS, SECURITIES REGULATION 1682-1757 (2d ed. 1961); 6 *id.* at 3820-65 (Supp. 1969) [hereinafter cited as LOSS]. In addition to these express provisions for civil liability, there is the burgeoning area of implied civil remedies, *e.g.*, in the areas of proxy violation and Rule 10b-5. *See generally* 2 *id.* at 932-56; 5 *id.* at 2879-925; 3 *id.* at 1763-97; 6 *id.* at 3869-925.

3 The statutes require that sanctions be in the public interest. *E.g.*, Sec. Ex. Act § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1970). This broad grant of administrative discretion allows for the imposition of no sanction at all, despite a violation, if, for example, no clear harm was caused by the violation and repetition seems unlikely.

4 Besides those mentioned below, present law also provides for sanctions against exchanges, Sec. Ex. Act § 19(a)(1), 15 U.S.C. § 78s(a)(1) (1970), exchange officers,

over the counter broker-dealers[6] (and applicants therefor) may be denied registration, censured, suspended from registration for up to one year or suffer revocation of registration.[7] Members of national securities exchanges[8] and of the National Association of Securities Dealers (NASD)[9] may be suspended for up to one year or expelled from membership by the Commission. Other persons may be censured, or suspended for up to one year, or barred from being an associate[10] of any (not just over the counter) broker-dealer[11] or investment adviser.[12] Associates of NASD members may be similarly suspended or barred.[13] Finally, persons serving or seeking to serve in certain capacities with registered investment companies or investment advisers thereto may be barred permanently or for whatever period the Commission deems appropriate from serving in any such capacities.[14] All of this is in addition to the sanctions for criminal violations: a fine of $10,000[15] and imprisonment for two years.[16]

This article explores the relationship between culpability and the imposition of administrative and criminal sanctions under the securities laws. The requirement of culpability, *i.e.*, moral blame-

Sec. Ex. Act § 19(a)(3), 15 U.S.C. § 78s(a)(3) (1970), the National Association of Securities Dealers (NASD), Sec. Ex. Act § 15A(*l*)(1), 15 U.S.C. § 78o-3(*l*)(1) (1970), and NASD officers, Sec. Ex. Act § 15A(*l*)(3), 15 U.S.C. § 78o-3(*l*)(3) (1970). These provisions have been virtually unused. *See* 2 Loss, *supra* note 2, at 1173, 1388; 5 *id.* at 3130-31.

5 Inv. Adv. Act § 203(e), 15 U.S.C. § 80b-3(e) (1970).

6 Sec. Ex. Act § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1970).

7 Registration with the Commission is required for over the counter broker-dealers by Sec. Ex. Act § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1970) and for investment advisers by Inv. Adv. Act § 203(a), 15 U.S.C. § 80b-3(a) (1970).

8 Sec. Ex. Act § 19(a)(3), 15 U.S.C. § 78s(a)(3) (1970).

9 *Id.* § 15A(*l*)(2), 15 U.S.C. § 78o-3(*l*)(2) (1970).

10 Defined as to broker-dealers in Sec. Ex. Act § 3(a)(18), 15 U.S.C. § 78c(a)(18) (1970); as to investment advisers in Inv. Adv. Act § 202(a)(17), 15 U.S.C. § 80b-2(a)(17) (1970).

11 Sec. Ex. Act § 15(b)(7), 15 U.S.C. § 78o(b)(7) (1970).

12 Inv. Adv. Act § 203(f), 15 U.S.C. § 80b-3(f) (1970).

13 Sec. Ex. Act § 15A(*l*)(2), 15 U.S.C. § 78o-3(*l*)(2) (1970).

14 Inv. Co. Act § 9(b), 15 U.S.C. § 80a-9(b) (1970).

15 Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970); Hold. Co. Act § 29, 15 U.S.C. § 79z-3 (1970); Inv. Co. Act § 49, 15 U.S.C. § 80a-48 (1970); Inv. Adv. Act § 217, 15 U.S.C. § 80b-17 (1970). The other acts have a $5,000 limit. Sec. Act § 24, 15 U.S.C. § 77x (1970); Trust Ind. Act § 325, 15 U.S.C. § 77yyy (1970).

16 Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970); Hold. Co. Act § 29, 15 U.S.C. § 79z-3 (1970); Inv. Co. Act § 49, 15 U.S.C. § 80a-48 (1970); Inv. Adv. Act § 217, 15 U.S.C. § 80b-17 (1970). The Securities and Trust Indenture Acts have a five year limit. Sec. Act § 24, 15 U.S.C. § 77x (1970); Trust Ind. Act § 325, 15 U.S.C. § 77yyy (1970).

worthiness, as a predicate to the imposition of these sanctions is a troubling question. It raises problems under the present statutory pattern, since that scheme consistently uses "willful violation" as a predicate to both administrative and criminal sanctions.[17] There is much doubt whether the willfully concept does or should mean the same thing in both contexts[18] and, if it does not, the dual usage invites confusion. In addition, the requirement of culpability raises problems for two major efforts to revise and codify the law: the Federal Criminal Code[19] and the Federal Securities Code (the Code).

The Code, a project of the American Law Institute, is a long range effort to codify federal securities regulation, and in particular the statutes administered by the Commission.[20] The codification movement was an outgrowth of the much older and continuing process of legislative reform.[21] Through codification it is hoped to: (1) simplify the complex statutory pattern inherent in the administration of six separate statutes; (2) eliminate incon-

17 The willfully concept appears in each of the criminal provisions. Sec. Act § 24, 15 U.S.C. § 77x (1970); Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970); Hold. Co. Act § 29, 15 U.S.C. § 79z-3 (1970); Trust Ind. Act § 325, 15 U.S.C. § 77yyy (1970); Inv. Co. Act §§ 37, 49, 15 U.S.C. §§ 80a-36 & -48 (1970); Inv. Adv. Act § 217, 15 U.S.C. § 80b-17 (1970). While not so pervasive a predicate to administrative sanctions, the willfully concept also appears in numerous provisions relating to administrative sanctions. Sec. Ex. Act §§ 6(b), 8(a), 15(b)(5)(A), (D) & (E), 15(b)(7), & 15A(*l*)(2)(B), 15 U.S.C. §§ 78f(b), h(a), o(b)(5)(A), (D) & (E), o(b)(7) & o-3(*l*)(2)(B) (1970); Inv. Co. Act §§ 17(h) & (i), 15 U.S.C. §§ 80a-17(h) & (i) (1970); Inv. Adv. Act §§ 203(e)(1) & (4), 203(f), 15 U.S.C. §§ 80b-3(e)(1) & (4), 80b-3(f) (1970).

18 *See generally* 2 Loss, *supra* note 2, at 1309-12; 5 *id.* at 3367-74.

19 The proposed new Federal Criminal Code appears likely, if enacted, to effect a major revision and standardization of the relationship between culpability and federal criminal liability, deemphasizing, if not abandoning, the willfully concept. A discussion of the Federal Criminal Code is beyond the scope of this article. *See* S. 1, 93d Cong., 1st Sess. § 1-2A1 (1973); H.R. 10047, 93d Cong., 1st Sess. § 302 (1973); NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAWS, FINAL REPORT OF THE NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAWS: PROPOSED NEW FEDERAL CRIMINAL CODE §§ 301-05 (1971) [hereinafter cited as BROWN COMM'N REPORT]; Weinreb, *Comment on Basis of Criminal Liability; Culpability; Causation: Chapter 3; Section 610* in 1 WORKING PAPERS OF THE NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAWS 105 (1970) [hereinafter cited as Weinreb and BROWN COMM'N WORKING PAPERS, respectively].

20 *See* remarks of Louis Loss, Annual Meeting of the American Law Institute in Washington, D.C., May 22, 1969, *reprinted in* 25 BUS. LAW. 27 (1969).

21 *Id.* at 29. Commission and industry study committees were formed in 1940-41, 1956, 1957, and 1959. They studied the problems plaguing the Commission and the industry, introduced legislation, and testified before Congress on some of the bills, but nothing happened. *Id.* The securities laws have, of course, been amended numerous times over the years.

sistencies among the various statutes; (3) rationalize various anomalies that have sprung up in the law, for example, in the area of Rule 10b-5; (4) develop new and more efficient disclosure devices; and (5) better coordinate the scheme of federal and state regulation.[22] Approximately half the Code has been drafted and approved by the Council of the American Law Institute.[23]

Throughout the Code the appropriate role of culpability and its articulation in the administrative and criminal contexts are of central importance. While the Code will preserve the present range of sanctions virtually unchanged,[24] it will change the statement of the predicates for the imposition of those sanctions. It will iron out inconsistencies in the present statutory pattern, a not inconsiderable achievement, particularly on the administrative side.[25] The Code will also differentiate between misrepresentations

22 *Id.* at 27, 27-28, 34-36.

23 *Reporter's Introductory Memorandum*, ALI FEDERAL SECURITIES CODE (Tent. Draft No. 3, April 1, 1974) at xv. The Council has approved drafts of the Code integrating the Securities Act of 1933 with the disclosure-oriented provisions of the Securities Exchange Act of 1934 (Tent. Draft No. 1, April 25, 1972); covering the whole complex of fraud, manipulation, and civil liability (Tent. Draft No. 2, March 1973); and the area of administration and enforcement (Tent. Draft No. 3, April 1, 1974). It is planned that future sections will cover the three specialized statutes, *i.e.*, Holding Company Act of 1935, Trust Indenture Act of 1939, and Investment Company Act of 1940, as well as the material relating to market control and regulation. *Id.* at xvi.

24 It removes the one year limit on suspensions, makes minor additions to the investment company relationships covered and adds censures to the sanctions which may be imposed on persons serving in investment company relationships. ALI FEDERAL SECURITIES CODE §§ 1507(a), 1511(a) (Reporter's Revision of Text of Tentative Drafts Nos. 1-3, October 1, 1974) [hereinafter cited as FSC]. The Reporter's Revision is the complete and current version of the Code including those parts of the text published separately in Tentative Drafts Nos. 1-3. While the Tentative Drafts have been submitted and approved by the Council of the ALI, the changes incorporated in the Reporter's Revision have not yet been submitted to the Council. The Reporter's Revision thus represents the Code as currently proposed by the Reporter. *See* FSC at xxi. Unless otherwise indicated, all references to provisions of the Code are to the Reporter's Revision. Since the Reporter's Revision does not include any Comments, all references to the Comments will indicate the appropriate Tentative Draft.

25 The grounds for the imposition of sanctions contain numerous variations among securities participants both as to the provisions for which violation can result in administrative sanctions and as to the description of the character of violation required to justify such sanctions. There is, for example, no reason why exchange members should be subject to sanctions only for violation of the Securities Exchange Act among the six. Nor is there reason to predicate sanctions for the violation of the Securities Exchange Act on willfulness, whatever that may mean, in the case of over the counter broker-dealers but not in the case of exchange or NASD members, or to require willfulness to impose sanctions on NASD members

and other violations in defining the degree of culpability required to warrant the imposition of sanctions, both administrative and criminal. And a tentative judgment has been made to discard the willfully concept in favor of the new formulations discussed below.[26]

In order to compare the present law with what may be expected from the Code this article first develops a framework within which one can analyze the relevance of culpability in the securities field. Thereafter, the article sets forth the present statutory pattern, the judicial and administrative interpretation of that legislation, and the changes proposed to be made by the Code. Based on the previously developed framework, the present law and Code are evaluated and alternatives to certain Code provisions are suggested.

I. The Relevance of Culpability

A. *The Willfully Concept*

At the heart of the present statutory pattern is the willfully concept, the collective term this article uses to refer to the various forms of usage dealing with a "willful violation." Willfully appears in the criminal provision of each of the federal securities statutes,[27] and is a prominent ingredient in the statutory delegations of administrative power to the Commission.[28] The willfully concept has, however, been pushed around unmercifully by legislatures, agencies and courts, from one end of the culpability spectrum to the other.

Looking solely to federal law, a recent extensive study in connection with development of the Federal Criminal Code indicates that the constructions of willfully fall into three broad categories:[29]

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for violation of the Securities Act but not for violations of the Securities Exchange Act. *See* statutes cited at notes 5-14 *supra*. Probably the most important change in scope wrought by this rationalization is that violation of Commission orders could result in administrative or criminal sanctions under the Code, whereas orders are not mentioned at all in the Securities or Securities Exchange Acts and are covered only by the criminal provisions of the other four acts. *Compare* note 94 *infra with* note 121 *infra*.

26 *See* FSC § 1507(a)-(d), Comment 6 (Tent. Draft No. 3, 1974).

27 *See* note 17 *supra*.

28 *See* note 17 *supra*.

29 *See* Weinreb, *supra* note 19, at 148-51.

criminal uses requiring an intent to do a specific wrong; criminal uses requiring a bad purpose of one sort or another; and some criminal and many administrative constructions requiring no element of bad purpose, but only conscious action. The Supreme Court has suggested five connotations[30] for the concept in criminal statutes in a widely cited and followed[31] opinion, and announced that willfulness does not necessarily imply a bad purpose when the proscribed activity is not wrong in itself.[32] Whatever the vitality of that notion on the criminal side, it seems to have prevailed in constructions of the willfully concept in non-criminal situations.[33] In sum the willfully concept is unusually chameleon-like, changing frequently and dramatically from one use to another.

The explanation for this unsatisfactory state of affairs is not hard to find: the inability of American society to reach a consensus on the required degree of culpability necessary to trigger a specified sanction in a particular situation. Resort to general principles of criminal and administrative law does little to advance the analysis. The three basic distinctions discussed below are often made by courts and commentators. However, when one attempts to elucidate the various factors that support such distinctions, the advisability of the distinctions becomes questionable, their impact inconclusive, and one is often forced to conclude that the criminal law's approach to culpability is schizophrenic.

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30 "Bad purpose"; "without justifiable excuse"; "stubbornly, obstinately, perversely"; "without ground for believing it is lawful"; "careless disregard whether or not one has the right so to act." United States v. Murdock, 290 U.S. 389, 394-95 (1933).

31 *E.g.*, United States v. Patillo, 431 F.2d 293, 297 (4th Cir. 1970). *Cf.* United States v. Budzanoski, 462 F.2d 443, 452 (3d Cir. 1972); United States v. Krosky, 418 F.2d 65, 67 (6th Cir. 1969).

32 United States v. Illinois Cent. R.R., 303 U.S. 239, 242 (1938).

33 *See* Goodman v. Benson, 286 F.2d 896, 900 (7th Cir. 1961) (Administrative action for willful violation of the Commodity Exchange Act, court holds: "[I]f a person 1) intentionally does an act which is prohibited — irrespective of evil motive or reliance on erroneous advice, or 2) acts with careless disregard of statutory requirements, the violation is willful."); American Surety Co. v. Sullivan, 7 F.2d 605, 606 (2d Cir. 1925) (Civil action for damages: "The word 'willful,' even in criminal statutes, means no more than that the person charged with the duty knows what he is doing."). Still not imputing bad purpose, but perhaps going further by suggesting an element of carelessness, is Binkley Mining Co. v. Wheeler, 133 F.2d 863, 871 (8th Cir. 1943) (Administrative action for willful violation of Bituminous Coal Code: "While infractions due to excusable neglect or mere mistake should not be classed as willful, there would be no justification for excluding . . . infractions which are inexcusable either because a Member acted deliberately or in plain disregard of his duty to inform himself before acting.").

B. *The Public Welfare/Other Offense Distinction*

The no-culpability criminal offense, enacted for the public welfare, best reflects the schizophrenic approach to the role of culpability in American criminal law. The classic judicial statement on the matter, Mr. Justice Jackson's opinion in *Morissette v. United States*,[34] effectively illuminates the problem:

> The contention that an injury can amount to a crime only when inflicted by intention is no provincial or transient notion. It is as universal and persistent in mature systems of law as belief in freedom of the human will and a consequent ability and duty of the normal individual to choose between good and evil. A relation between some mental element and punishment for a harmful act is almost as instinctive as the child's familiar exculpatory "But I didn't mean to" . . . .[35]
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> [But there is also] a century-old but accelerating tendency, discernible both here and in England, to call into existence new duties and crimes which disregard any ingredient of intent. . . . [Society having become much more complex, the concomitant] dangers have engendered increasingly numerous and detailed regulations which heighten the duties of those in control of particular . . . activities that affect public health, safety or welfare.
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> While many of these duties are sanctioned by a more strict civil liability, lawmakers, whether wisely or not, have sought to make such regulations more effective by invoking criminal sanctions . . . . This has confronted the courts with a multitude of prosecutions, based on statutes or administrative regulations, for what have been aptly called "public welfare offenses." . . . While such offenses do not threaten the security of the state in the manner of treason, they may be regarded as offenses against its authority, for their occurrence impairs the efficiency of controls deemed essential to the social order as presently constituted. In this respect, whatever the intent of the violator, the injury is the same, and the consequences are injurious or not according to fortuity. Hence, legislation applicable to such offenses, as a matter of policy, does not specify intent as a necessary element. The accused, if he does not will the violation, usually is in a position to prevent it with no more care than society might reasonably expect and no more exertion than it might reasonably exact from one who assumed his responsibilities. Also, penalties commonly are relatively small, and conviction does no grave damage to

34 342 U.S. 246 (1952).
35 *Id.* at 250-51.

> an offender's reputation. Under such considerations, courts have turned to construing statutes and regulations which make no mention of intent as dispensing with it and holding that the guilty act alone makes out the crime. This has not, however, been without expressions of misgiving.[36]

The public welfare offense notion has been taken quite far by the Supreme Court — even to the extent of finding a corporation president guilty of a misdemeanor for shipping adulterated and misbranded drugs in interstate commerce when nobody in the corporation was aware of the problem, the president had nothing to do with the particular shipment, and the corporation was acquitted of the same charges.[37] The misgivings are substantial and continuing, both among commentators[38] and on the Court.[39] Few unequivocally embrace criminal sanctions without culpability, and the weight of scholarly commentary is decidedly against them. Legislatures embrace them or equivocate out of a varying mixture of sloth and alleged necessity. Courts may sometimes avoid them, but if faced with an unequivocal statute accept them on grounds of the practical exigencies of regulating modern society. While a situation posing constitutional difficulties for liability without fault could no doubt be imagined,[40] the debate has generally been confined to policy and statutory interpretation.[41] So far as the securities laws are concerned the issues relate solely to interpretation of the present statutes and consideration of what the proposed Code should do in this regard.

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36 *Id.* at 253-56.

37 United States v. Dotterweich, 320 U.S. 277 (1943).

38 *See, e.g.*, L. FULLER, THE MORALITY OF LAW 77-78 (rev. ed. 1969); J. HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 325-59 (2d ed. 1960); H. SILVING, CONSTITUENT ELEMENTS OF CRIME 77-87 (1967); G. WILLIAMS, THE MENTAL ELEMENT IN CRIME 35-37 (1965); H. M. Hart, *The Aims of Criminal Law*, 23 LAW & CONTEMP. PROB. 401 (1958). *But see* Brady, *Strict Liability Offenses: A Justification*, 8 CRIM. L. BULL. 217 (1972).

39 *See* United States v. International Minerals & Chemical Corp., 402 U.S. 558, 569 (1971) (holding of Court that criminal information was adequate notwithstanding failure to allege knowledge of the regulation violated where the statute made knowing violations of regulations a misdemeanor labeled "a perversion of the purpose of criminal law," Stewart, J., dissenting).

40 *But see* Chicago, B. & Q. Ry. v. United States, 220 U.S. 559, 578 (1911) ("The power of the legislature to declare an offense, and to exclude the elements of knowledge and due diligence from any inquiry as to its commission, cannot, we think, be questioned.")

41 *E.g.*, United States v. International Minerals & Chemical Corp., 402 U.S. 558 (1971); Morissette v. United States, 342 U.S. 246 (1952); United States v. Dotterweich, 320 U.S. 277 (1943).

C. *The Remedial/Penal Distinction*

A similarly troubling duality — the remedial/penal distinction — is of particular concern on the administrative side. Characterization of a statute or regulation as remedial means that the agency has greater flexibility and can mete out sanctions with somewhat less concern for the recipient thereof than is the case under provisions dubbed penal.[42] The securities statutes and disciplinary proceedings thereunder are said to be remedial.[43] But if a reviewing court thinks the Commission went too far in imposing a sanction, it may reverse on the ground that the Commission's action was penal, not remedial.[44]

The problem with the remedial/penal distinction is that it merely restates the issue. The question is what degree of culpability is going to be required before sanctions are imposed. A judicial finding that a statute is penal necessarily implies a legal conclusion that high culpability is required. But there is nothing in the penal label that furthers that conclusion. It could have been reached without resort to the remedial/penal distinction. And one suspects that judicial reference to such a labeling procedure often obscures more thorough analysis.[45] There is Supreme Court support for the rejection of the remedial/penal distinction in the securities field,[46] but the dichotomy is still made by lower federal courts, and on occasion by the Supreme Court.[47] Whatever the analytic worth of the remedial/penal distinction, as a practical matter the very existence of the distinction implies that in some case culpability will be required.

D. *The Administrative/Criminal Distinction*

A final distinction is between criminal and administrative proceedings. Since culpability need not always be a prelude to

42 *Compare* 3 J. SUTHERLAND, STATUTES & STATUTORY CONSTRUCTION § 65.02 n.28 (4th ed. C. Sands 1974) *with* 3 *id.* § 65.03 n.4. *See generally* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 2.13 (1958).

43 *E.g.*, SEC v. Ralston Purina Co., 246 U.S. 119, 126 (1953); SEC v. Continental Tobacco Co., 463 F.2d 137, 155 (5th Cir. 1972); 2 Loss, *supra* note 2, at 1173, 1305; 5 *id.* at 3362.

44 Beck v. SEC, 430 F.2d 673 (6th Cir. 1970).

45 *See* 1 Loss, *supra* note 2, at 480-81, n.67 (remedial/penal distinction labeled a "rat race").

46 *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353-55 (1943).

47 *Compare* 1 Loss, *supra* note 2, at 480-81, n.67 *with* 4 *id.* at 2498.

criminal punishment, a fortiori, the same should hold for administrative sanctions. A high culpability predicate to administrative sanctions for securities law violations would be inappropriate at times and frequently is not required by present law.

All investors seek a return on their investment, whether in the form of current income or capital appreciation. A more or less competitive market economy makes inevitable a range of returns from total loss to enormous profit; the Commission obviously can neither guarantee against total loss nor guarantee a particular rate of return. Instead the Commission attempts to ensure efficient operation of the capital market (including investor confidence therein) by insisting that investors have a reasonable opportunity to evaluate the risks of prospective investments before parting with their money[48] and by eliminating unnecessary friction from securities industry professionals in capital transfers.

The Commission's role in ensuring effective operation of the American capital market goes far beyond rooting out those intent upon separating others from their funds through the medium of securities. Were the Commission so restricted, a universal requirement of culpability as a predicate to sanctions, both criminal and administrative, might well be desirable. But the Commission must go much farther, at least in part to compensate for the utter inability of investors in today's complex society to approach the "perfect knowledge" which competitive economic theory tells us is necessary to produce optimal capital mobility. Thus the Commission attempts to foster the provision of knowledge to prevent unnecessary shortfall from the theoretical ideal, to prevent future imperfection in the operation of the capital market.

This preventive role has several important ramifications for the role of culpability in the imposition of sanctions. First, it means that the statutory and administrative rules regulating the industry cannot be as clear and definitive as might be desired, since a certain amount of flexibility is necessary. Thus, imposed upon the intricacy of the capital market institution is a correspondingly

48 Compare the disclosure oriented federal policy with the "fair, just and equitable" standard of some state securities laws which entails explicit governmental judgment of at least a minimal likelihood of success before corporations are allowed to solicit investors' funds. *See generally* 1 Loss, *supra* note 2, at 121-28; 4 *id.* at 2270-75.

intricate complex of statutory and administrative rules. The iterative process of institutional change produced by changing business practices and Commission tinkering (to respond to changes in business conditions and regulatory philosophy as well as to seek closer adherence of practice to that philosophy) inevitably introduces a degree of uncertainty and difficulty in compliance. Hence, the possibility of the accidental and unknowing violation arises.

Second, it renders financial gain or loss in particular transactions, the overriding interest of participants in the capital market, logically, though not practically, irrelevant. Rather the disclosure-oriented philosophy of the federal securities laws looks for explicit compliance with the technical requirements of disclosure as an objective measure of wrongdoing. Under such a system, where disclosure is the cutting edge in the gradual dismemberment of the doctrine of caveat emptor, inadvertent non-compliance must be condemned.

Finally, the Commission's preventive role demands that culpability not be a universal requirement for the imposition of administrative sanctions. Various harmful, though perfectly innocent and faultless, occurrences must be regulated. For example, defective registration statements should not be allowed to become effective,[49] and insolvent brokers should not be allowed to deal further with the public.[50] Culpability may or may not be present in such cases; it is irrelevant. Yet sanctions (denial of access to the capital market[51] and banishment from the securities business, respectively)

49 Sec. Act §§ 5, 7, 8, 15 U.S.C. §§ 77e, g, h (1970), give the Commission power to prevent a defective registration statement from becoming effective.

50 Sec. Ex. Act §§ 8(b), 15 (b)(5), 15 U.S.C. §§ 78h(b), 78o(b)(5) (1970) give the Commission power to suspend or revoke the registration of an insolvent broker.

51 Denial of registration statement effectiveness, or a stop order proceeding after the effective date, are not strictly analogous to the sanctions against securities professionals, for the former relate only to an existing violation and its correction, while the latter may affect the respondent's future participation in the securities industry, wholly independent of the violation for which the sanction is imposed. Nevertheless, stop orders are sanctions, for they deny the issuer access to the capital market. And the sanctions against securities industry professionals are imposed for the same reason — to keep the marketplace pure. *Cf.* 2 Loss, *supra* note 2, at 1305. The law logically could provide for similarly future-oriented sanctions, *e.g.*, a ban on access to the capital market for a period of time, against issuers or persons associated with the violations. Of course, with a few exceptions — delisting of securities pursuant to Sec. Ex. Act § 19(a)(2), 15 U.S.C. § 78s(a)(2) (1970), and regulation of investment companies under the Investment Company Act — it

certainly are employed. Nor is the Commission explicitly required to prove culpability to obtain an injunction against violations of the securities laws.[52] Although as a practical matter the requirement that future violations be expected[53] means that culpability will usually be present in injunction cases, it need not always be.[54] And being subject to such injunctions suffices without more to justify Commission imposition of administrative sanctions, including permanent exclusion from the securities business.[55] Moreover, the Commission may cause members of any national securities exchange[56] or of the NASD[57] to be suspended for up to a year or expelled from membership for violating the Securities Exchange Act or any rule thereunder. Culpability is not required.[58] Finally, administrative sanctions may be taken against a person because of past misdeeds that resulted in either criminal or administrative sanctions. No present culpability is required.[59]

E. *An Uneasy Resolution*

The characterization of a securities law violation as an administrative, remedial, public welfare offense would imply that cul-

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does not. The advisability of this gap and sanctions against issuers and investment companies generally are beyond the scope of this article. The focus here is on the future-oriented sanctions imposed after the particular violation has ended — administrative sanctions against securities industry professionals and criminal sanctions generally.

52 *See* FSC § 1515(a) and statutory source provisions cited at FSC § 1515, Comment (Tent. Draft No. 3, 1974). *See generally* 3 Loss, *supra* note 2, at 1975-83; 6 *id.* at 4108-23.

53 FSC § 1515(a) and note.

54 Enjoining an insolvent broker from conducting further business is an example. *See* 3 Loss, *supra* note 2, at 1979; 6 *id.* at 4116.

55 This applies to over the counter broker-dealers, Sec. Ex. Act § 15(b)(5)(c), 15 U.S.C. § 78o(b)(5)(c) (1970); investment advisers, Inv. Adv. Act § 203(e)(3), 15 U.S.C. § 80b-3(e)(3) (1970); and associates of any broker-dealer, Sec. Ex. Act § 15(b)(7), 15 U.S.C. § 78o(b)(7) (1970); or investment adviser, Inv. Adv. Act § 203(f), 15 U.S.C. § 80b-3(f) (1970). It is retained in the Code. FSC § 1507(a)(3).

56 Sec. Ex. Act § 19(a)(3), 15 U.S.C. § 78s(a)(3) (1970).

57 Sec. Ex. Act § 15A(*l*)(2), 15 U.S.C. § 78o-3(*l*)(2) (1970).

58 A culpability requirement is not to be inferred in either of these provisions, for § 15A(*l*)(2) gives identical treatment for *willful* violations of the Securities Act.

59 Sec. Ex. Act §§ 15(b)(5)(B) & (F), 15(b)(7), 15 U.S.C. §§ 78o(b)(5)(B) & (F), 78o(b)(7) (1970); Inv. Adv. Act §§ 203(e)(2) & (6), 203(f), 15 U.S.C. §§ 80b-3(e)(2) & (6), 80b-3(f) (1970). The applicability of a stigma for past conduct is broadened for criminal convictions and dropped for past Commission action in the Federal Securities Code. FSC § 1507(a)(2); *see* FSC § 1507(a)-(d), Comments 5(f) & 6(c) (Tent. Draft No. 3, 1974).

pability is not a relevant consideration in imposing a sanction. And even if the sanction were criminal instead of administrative, a not much higher standard of culpability would be required.

Nevertheless, the notion of culpability as a predicate to sanctions cannot be dismissed out of hand in the securities law context, even on the administrative side. The administrative sanctions meted out amount to rather severe punishment,[60] whether or not acknowledged as such. On the criminal side, the stigma of conviction plus the inconvenience of two years in prison[61] and a $10,000 fine[62] equals harsh treatment for any person who is morally blameless for his transgression. In addition, the present statutory language is at least suggestive of culpability, as illustrated by its infatuation with the willfully concept.

Perhaps one day realization that government-inflicted punishment by whatever name still feels the same[63] will lead to a systematic reexamination of the administrative/criminal, remedial/penal and public welfare/other offense distinctions, and the appearance of a more satisfactory way to classify and deal with government-inflicted punishment. Pending such a development, and in light of the manifest uneasiness over low- and no-culpability punishment, legislative draftsmen in fields of economic regulation should closely scrutinize claimed needs for such provisions. In view of the morass of statutory construction to which such uneasiness condemns courts faced with application of such provisions, the least which should be demanded of legislative draftsmen is close attention to the statutory formulation of the predicates to low- and no-culpability sanctions. They must face up to the legislative responsibility of defining those predicates by first deciding the relevance of culpability and then attempting to record the decision in unmistakable language.

Measured against that standard it is no wonder that the possibility of retaining the willfully concept in both the administrative and criminal provisions of the Code has been labeled "a counsel of despair."[64] The Code may not have resolved the relevancy of cul-

60 *See* text accompanying notes 4-14 *supra.*
61 *See* note 16 *supra.*
62 *See* note 15 *supra.*
63 *Cf.* 5 Loss, *supra* note 2, at 3136-37, 3380; 6 *id.* at 3535-36.
64 FSC § 1507(a)-(d), Comment 6(a)(i) (Tent. Draft No. 3, 1974).

pability any better than the present system,[65] but it at least spells out in explicit terms different culpability predicates for different violations. Common sense suggests that the degree of culpability which would justify the imposition of very light administrative sanctions as "in the public interest"[66] is quite different from that which would justify criminal conviction, fine and imprisonment. The inherent dissimilarity between the Commission's preventive role on the administrative side and the appropriate role of the criminal law reinforces this proposition,[67] as does the severity of the criminal sanctions which may be imposed for violation of the securities laws. The Code recognizes such distinctions.

Of course, a word may have different meanings in different statutes or even in different provisions of a single statute.[68] But the deliberate and unnecessary use of a single term for different purposes within a single statute, particularly where the difference is merely implicit, can only produce unnecessary confusion. And if willfully has the same meaning in both the administrative and criminal contexts, there are two possibilities. A stringent standard requiring some degree of evil intent might hamstring the Commission, for there are certainly instances in which culpability is irrelevant to the Commission's preventive role requiring the Commission to mete out administrative sanctions, but in which criminal prosecution would be inappropriate.[69] On the other hand, with a looser standard, appropriate for administrative purposes, the implication would be that criminal liability could be imposed without culpability.

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65 *See, e.g.*, text following note 266 *infra*.

66 *See* note 3 *supra*.

67 The public welfare offense notion muddies the distinction, but public welfare offense analysis seems inapplicable to the criminal provisions of the securities laws. *See* text at notes 238-244 *infra*.

68 *Cf.* Spies v. United States, 317 U.S. 492, 497-98 (1943); 2 Loss, *supra* note 2, at 1309.

69 Of course the Commission could seek an injunction without facing the willfully standard. *See* text accompanying notes 52-54 *supra*. Perhaps Congress intended that the Commission resort to the courts except in cases of egregious violations which would also justify criminal prosecution, for the acts were drafted in a much earlier era of administrative law and federal regulation. Whatever standard is now required for criminal prosecution, the Commission certainly is not required to resort to the courts before imposing administrative sanctions in cases of less than egregious violations.

Thus, at the outset, it is apparent that the Code's more detailed specification of the predicates necessary for the imposition of sanctions fills a void in the present system. Sections II, III and IV of this article discuss in more detail how successful those provisions of the Code are in dealing with society's underlying aims in imposing administrative and criminal sanctions. In order to facilitate that analysis, a chart is included at this point which summarizes the culpability requirements for administrative and criminal sanctions under present law and the Code. The classifications and culpability predicates are explained in greater detail in the appropriate sections below. The criminal provisions apply, of course, to all. On the administrative side, the Code provisions apply to professionals and professional associates. The administrative provisions shown under present law are those applicable to over the counter broker-dealers and investment advisers, source of the more broadly applicable Code provisions. The chart shows and the analysis below adopts a dichotomy between violations involving and not involving misrepresentations for present law as well as the Code, despite the fact that the present statutory pattern makes no such distinction. This has been done to facilitate comparison of the present and proposed provisions.

II. Administrative Sanctions Without a Present Violation of the Securities Laws

Administrative sanctions against securities industry participants without a present violation of law and hence without present culpability demonstrate the importance of the Commission's preventive role in the operation of the capital market.

A. *Vicarious Liability*

Various provisions impose responsibility for subordinates upon securities industry participants. The predicates to imposing sanctions range from pure guilt by association to whatever culpability inheres in failure to supervise subordinates in a reasonable manner.

Culpability Predicates for Federal Securities Law Sanctions

	Administrative		Criminal	
	Present	Code	Present	Code
Sanctions for the Present Violation of Securities Laws				
Violations other than misrepresentations	Willfully	Without reasonable justification or excuse	Willfully	Intentionally[a] or recklessly[b]
Violations Involving Misrepresentations	Willfully	Scienter[c]	Willfully	Scienter[c]
Sanctions Without the Present Violation of Securities Laws				
Vicarious Liability	Violation must have occurred	Violation need not have occurred		
Prior Violations				
Convicted	Suffices without more	Suffices without more		
Presently barred or suspended	Suffices without more	Dropped		
Presently enjoined	Suffices without more	Suffices without more		

[a]Person's purpose is to engage in conduct of the specified kind or to cause the specified result AND he knows (including awareness of a high probability, unless he actually believes otherwise) that the specified attendant circumstances exist. Knowledge of the provision violated is not required and advice of counsel is relevant but not conclusive.

[b]Person engages in the conduct in conscious and clearly unjustifiable disregard of a substantial likelihood of the existence of the relevant facts or risks AND his disregard involves a gross deviation from acceptable standards of conduct. Knowledge of the provision violated is not required and advice of counsel is relevant but not conclusive.

[c] Person knows (including awareness of a high probability, unless he actually believes otherwise) that the matter is otherwise than as represented OR does not have the confidence in its existence or nonexistence that his representation expresses or implies OR knows (including awareness of a high probability, unless he actually believes otherwise) that he does not have the basis for his representation that it expresses or implies.

Under present law, investment advisers and over the counter broker-dealers are subject to discipline if a professional[70] associate has sinned.[71] Culpability and the question of whether the professional associate/sinner should have been or was adequately supervised are irrelevant. This is pure guilt by association. To be distinguished is the provision for disciplining such broker-dealers or investment advisers for their own failure to supervise.[72] If a person subject to supervision commits a violation of certain of the securities laws, the superior broker-dealer or investment adviser may be disciplined if he failed reasonably to supervise the subordinate.[73] The burden of proof apparently is on the Commission, although a contrary argument might be made by implication from the statutory language.

The Code makes a fairly substantial change in the logic of the foregoing statutory pattern, although the practical import appears to be nugatory. Guilt by association is abandoned. A broker-dealer

70 Both present law and the Code differentiate between types of associates in the respective definitions of associate. *See* Sec. Ex. Act § 3(a)(18), 15 U.S.C. § 78c(a)(18) (1970); FSC § 206. The professional/non-professional dichotomy used here is a shorthand for the statutory references, with non-professional referring to associates with duties which are solely clerical, ministerial or, in the case of the Code, in areas not subject to regulation under the Code.

71 Sec. Ex. Act § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1970); Inv. Adv. Act § 203(e), 15 U.S.C. § 80b-3(e) (1970). The "sins" are those for which investment advisers and broker-dealers may be disciplined if they "commit" them — certain omissions or willful misstatements, convictions, injunctions, willful violations, willful aiding or abetting of violations, failure to supervise reasonably another who commited a violation, or being banned or suspended from the securities industry. Sec. Ex. Act § 15(b)(5)(A)-(F), 15 U.S.C. § 78o(b)(5)(A)-(F) (1970); Inv. Adv. Act § 203(e)(1)-(6), 15 U.S.C. § 80b-3(e)(1)-(6) (1970).

72 Sec. Ex. Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970); Inv. Adv. Act § 203(e)(5), 15 U.S.C. § 80b-3(e)(5) (1970).

73 The standards for reasonable supervision — following established procedures adequate to reasonably (NOT perfectly) prevent violations by subordinates — are substantially identical under present law and the Code. Sec. Ex. Act § 15(b)(5)(E)(i)-(ii), 15 U.S.C. § 78o(b)(5)(E)(i)-(ii) (1970); Inv. Adv. Act § 203(e)(5)(A)-(B), 15 U.S.C. § 80b-3(e)(5)(A)-(B) (1970); FSC § 1507(e).

Discipline for failure to supervise a subordinate who committed a violation is distinguishable from discipline for having a professional associate who committed a violation, for two reasons. The guilt by association sanction applies to willful violations; the willfully concept is conspicuously absent in the failure to supervise provision. Second, the failure to supervise provision applies to the violations of any person subject to supervision, the guilt by association provision only to professional associates.

The distinction here also lends some small measure of support to the claim that the willfully concept was intended to have some sort of bad purpose connotation.

or investment adviser may be disciplined for the sins of a professional associate only if the broker-dealer or investment adviser failed reasonably to supervise the associate.[74] The effect of a finding of wrongdoing by the professional associate is only to place the burden of proving reasonable supervision on the broker-dealer or investment adviser.[75] This change may have practical effect on two fronts. It would seem to rule out sanctions when the professional associate's wrongdoing occurred prior to his becoming an associate, although an argument could be made that reasonable supervision includes hiring procedures to weed out the statutory undesirables.[76] The size of this gap would depend upon the degree to which the Commission, directly through registration of the professional associates or indirectly through influence on the exchanges and the NASD, could reach abuses.[77] Its importance could hardly be great, anyway, since violations after employment could still be reached. Besides, the Commission's power seems sufficiently Draconian with regard to the past history of prospective securities industry participants without this extra measure.

The change would also prevent discipline of broker-dealers or investment advisers for the wrongs of professional associates not subject to supervision (and hence not within Federal Securities Code § 1507(a)(5)). Not entirely clear is whether there could be professional associates not subject to supervision. The guilt by association device of the present law is plainly intended to facilitate discipline of organizational broker-dealers and investment advisers for the wrongdoing of their human agents. Query, for example, whether partners in a broker-dealer partnership are subject to supervision in the sense of Federal Securities Code § 1507(a)(5). Probably the answer is that if they are not, their acts are attributable to the organization anyway on an agency theory.[78] Thus while the effects of the change appear to be minimal, they may be unanticipated, for they are not addressed by the Comment

74 *See* FSC § 1507(a)(5).

75 FSC § 1507(b)(2).

76 And the indication even under present law is that the broker-dealer should not be held for pre-association sins of professional associates unless he knew or should have known of them. *See* 5 Loss, *supra* note 2, at 3380.

77 *Cf.* Sec. Ex. Act § 15A(b)(4), 15 U.S.C. § 78o-3(b)(4) (1970); 5 Loss, *supra* note 2, at 3482-85.

78 *See* 5 Loss, *supra* note 2, at 3374.

to the Code that the new provision "makes obsolete the [present] scheme . . . whereby an associate's disqualification is attributed to the broker-dealer . . . ."[79]

Under both present law[80] and the Code, administrative sanctions may be imposed against a person relating to the activity of others who are not professional associates only for a failure reasonably to supervise subordinates, and the Commission has the burden of establishing such failure. A failure to supervise provision helps to prevent the principals from avoiding the consequences of the wrongs they encouraged or tolerated among their subordinates, as does the guilt by association device discussed above. It is an important, if not necessary, weapon in the administrative arsenal.

The Code, however, is both narrower and broader than present law. It is narrower with regard to the persons subject to sanctions. Present law allows the imposition of sanctions against broker-dealers or investment advisers[81] and both professional and non-professional associates[82] for failure reasonably to supervise persons subject to their supervision; the Code does not cover the non-professional associate.[83] The Code is broader with regard to the grounds for imposition of sanctions, for it does not require that the subordinate have violated the law,[84] while present law does.[85]

Viewed from the perspective of the extent to which Commission interference with the internal management of securities industry participants is desirable, the changes — one broadening, one narrowing — appear inconsistent in the abstract. The narrowing change is of virtually no practical importance, however. It simply limits the Commission's ability to reach deep into management to proceed against non-professionals who failed to adequately supervise others. But there are not likely to be many persons below the professional level with significant supervisory responsibilities, and

79 FSC § 1507(a)-(d), Comment 6(f)(ii) (Tent. Draft No. 3, 1974).

80 *See generally* 5 Loss, *supra* note 2, at 3375-77.

81 Sec. Ex. Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970); Inv. Adv. Act § 203(e)(5), 15 U.S.C. § 80b-3(e)(5) (1970).

82 Sec. Ex. Act § 15(b)(7), 15 U.S.C. § 78o(b)(7) (1970); Inv. Adv. Act § 203(f), 15 U.S.C. § 80b-3(f) (1970).

83 *See* FSC §§ 206, 1507(a), (a)(5) & (c).

84 FSC § 1507(a)(5) & Comment 6(f)(i) (Tent. Draft No. 3, 1974).

85 Sec. Ex. Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970); Inv. Adv. Act § 203(e)(5), 15 U.S.C. § 80b-3(e)(5) (1970).

the likelihood of the Commission, given the scope of its responsibilities and resource constraints, pursuing persons at that level is minimal.

The broadening, on the other hand, must be justified on practical grounds. It plainly would be drafting madness to attempt specification of what sorts of violations by subordinates should give rise to sanctions against their superiors. Given the complexity of the securities laws it seems quite likely that some violations would be present in situations involving inadequate supervision. When the Commission's concern is with inadequate management which is likely to lead to serious violations in the future, it does seem a bit wasteful to require the establishment of a present violation, however trivial, as a predicate to dealing with the real problem. The same end could also be accomplished by simply making inadequate supervision per se unlawful, but that would also make it criminal,[86] unless the criminal provision were changed to exclude it. Criminality for sloppy management hardly seems justifiable, and it is difficult to argue with the Code formulation as a means of avoiding that result.

Nevertheless, the extension of the inadequate supervision sanction to cases in which no independent violation of the Code has occurred is troubling, even though it probably would be used only against fringe violators in extreme cases, with judicial review available to prevent abuse. The expansion at least opens the possibility for Commission second guessing of management. It is doubtful whether the Commission has the management skill or the staff time to contribute significantly to the effectiveness of the capital market through this enlarged prophylactic device. If a particular procedure is of sufficient importance the Commission can command adherence by making it a rule. The power to impose sanctions without a rule violation is at best of marginal usefulness, and that usefulness does not adequately compensate for the potential power of the Commission to interfere with firm management and impose sanctions out of all proportion to the malady in cases where no harm has yet been done.

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86 *See* FSC § 1517(a)(2).

B. *Prior Violations*

The Commission also has the power to impose sanctions for prior violations of the law in three situations. First, it may censure, or deny, suspend, or revoke the registration of, any broker-dealer or investment adviser who "has been convicted within ten years preceding the filing of the application [for registration] or at any time thereafter of any felony or misdemeanor" falling into one of four categories, generally dealing with the securities industry.[87] The Commission thus has broad discretion to exclude ex-convicts from the securities industry. The Code provision is somewhat more wide sweeping in that it covers "crime[s] involving a security or any aspect of the securities business or reflecting on [the registrant's] qualifications" to work in the securities industry.[88]

The culpability of the recipient of the sanctions varies with the culpability required for conviction of the particular crime and the passage of time. The sanctions could be in response to a present conviction or one of several years ago. This provision quite evidently serves two purposes: to punish malefactors within the securities industry by banishing them, and to exclude *ab initio* persons thought to be likely candidates for future wrongdoing of a nature that might hamper effective operation of the capital market. Culpability is relevant to the first purpose, but really not to the second. Given the peculiar susceptibility of the securities industry to crime,[89] and the importance of public confidence in the capital market, reposing such discretion in the Commission is justified. Discretion is preferable to an outright ban because it allows a case-by-case determination. And judicial review safeguards against at least outrageous abuses of discretion.

Second, both present law and the Code permit the imposition of administrative sanctions against persons permanently or tempo-

87 *See* Sec. Ex. Act § 15(b)(5)(B), 15 U.S.C. § 78o(b)(5)(B) (1970); Inv. Adv. Act § 203(e)(2), 15 U.S.C. § 80b-3(e)(2) (1970); *See generally* 2 Loss, *supra* note 2, at 1303-05; 5 *id.* at 3364-65.

88 FSC § 1507(a)(2). In addition, the Reporter's Revision eliminates the ten year limitation found in the present law and originally included in the Code. *See* FSC § 1507(a)(2), Note; FSC § 1507(a)(2) (Tent. Draft No. 3, 1974).

89 A susceptibility resulting from the high concentration of liquid, portable assets (which makes theft easy), and the complexity involved in investing (which facilitates fraud).

rarily enjoined from certain activities relating to the securities, banking or insurance industries.[90] The rationale and desirability for this power parallel those relating to sanctions imposed for criminal convictions, as does the role of culpability.

Lastly, present law permits the imposition of administrative sanctions against over the counter brokers and dealers, associates of any brokers and dealers, investment advisers, and associates of investment advisers solely on the ground that they are already subject to a Commission order, as distinct from a court approved injunction, barring or suspending them from being associates of brokers, dealers or investment advisers.[91] Perhaps the rationale is that the Commission is able to avoid the trouble of extended new proceedings if the person gets into trouble again. The provision is unnecessary because the Commission can impose a heavier sanction in the original proceeding if one is justified, unwise because it is a disincentive to the finality of proceedings, and distasteful because it smacks of gratuitous double jeopardy. With regard to culpability the suggestion is that no greater degree is required for serious than for minor sanctions. This predicate for administrative sanctions is wisely abandoned by the Code.[92]

III. Administrative Sanctions for a Present Violation of the Securities Laws

The present statutes do not differentiate between violations involving and not involving misrepresentations. They do, however, differentiate in an utterly irrational manner among securities industry participants both as to the provisions for which violation can result in administrative sanctions and as to the description of the character of violation required to justify such sanctions.[93]

90 Sec. Ex. Act § 15(b)(5)(C), 15 U.S.C. § 78o(b)(5)(C) (1970); Inv. Adv. Act § 203(e)(3), 15 U.S.C. § 80b-3(e)(3) (1970); FSC § 1507(a)(3). *See generally* 2 Loss, *supra* note 2, at 1305-07; 5 *id.* at 3365-66.

91 Sec. Ex. Act § 15(b)(5)(F), 15 U.S.C. § 78o(b)(5)(F) (1970); Inv. Adv. Act § 203(e)(6), 15 U.S.C. § 80b-3(e)(6) (1970). *See generally* 5 Loss, *supra* note 2, at 3377, 3384.

92 *See* FSC § 1507(a)-(d), Comment 5(f) (Tent. Draft No. 3, 1974).

93 The Commission manages to reach all law violating securities industry participants on a more or less consistent basis. First, there is great overlap between the categories, with many persons wearing more than one of the statutory hats. Second,

Under present law, investment advisers, associates thereof, over the counter broker-dealers, associates of any broker-dealers, and persons related to investment companies are subject to sanction if they: (1) willfully violated any of the Securities, Securities Exchange, Investment Company or Investment Advisers Acts or any rule[94] thereunder;[95] (2) willfully aided, abetted, counseled, commanded, induced, or procured a violation (not necessarily willful) of such a provision by another;[96] (3) willfully misstated a material fact in any application for or Commission proceeding regarding registration or in any report required[97] to be filed under the applicable act; [98] or (4) omitted (not necessarily willfully) a material fact required to be stated in such an application or report.[99] Exchange members and officers may be disciplined by the Commission if they: (1) violated (not necessarily willfully) the Securities Exchange Act or a rule thereunder; or (2) effected a transaction

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exchange member is broadly defined. Sec. Ex. Act § 3(a)(3), 15 U.S.C. § 78c(a)(3) (1970). *See generally* 2 Loss, *supra* note 2, at 1172. Third, Sec. Ex. Act § 15(b)(7), 15 U.S.C. § 78o(b)(7) (1970), applies to associates of any broker-dealer, which suffices to reach just about anybody in the industry. *See* 5 Loss, *supra* note 2, at 3132. Finally, the interpretation given the willfully concept is tantamount to deleting it from the statute.

94 The term "rules" herein includes stautory references to regulations.

95 Sec. Ex. Act §§ 15(b)(5)(D) & (b)(7), 15 U.S.C. §§ 78o(b)(5)(D) & (b)(7) (1970); Inv. Co. Act § 9(b)(2), 15 U.S.C. § 80a-9(b)(2) (1970); Inv. Adv. Act §§ 203(e)(4) & (f), 15 U.S.C. §§ 80b-3(e)(4) & (f) (1970). *See generally* 2 Loss, *supra* note 2, at 1307-12; 5 *id.* at 3366-74. On the parallels between the Sec. Ex. Act and the Inv. Adv. Act *see generally* 2 Loss, *supra* note 2, at 1402-08; 5 *id.* at 3514-17.

96 Sec. Ex. Act §§ 15(b)(5)(E) & (b)(7), 15 U.S.C. §§ 78o(b)(5)(E) & (b)(7) (1970); Inv. Co. Act § 9(b)(3), 15 U.S.C. § 80a-9(b)(3) (1970); Inv. Adv. Act §§ 203(e)(5) & (f), 15 U.S.C. §§ 80b-3(e)(5) & (f) (1970).

The aider and abettor provisions in the present law present another instance of the illogical statutory pattern of inclusion and omission of the willfully concept. It is included in the aider and abettor provision applicable to over the counter broker-dealers, Sec. Ex. Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970), *see generally* 5 Loss, *supra* note 2, at 3374-75, but not in the parallel provision for investment advisers. Inv. Adv. Act § 203(e)(5), 15 U.S.C. § 80b-3(e)(5) (1970). The Code aider and abettor provision substitutes the successors to the willfully concept—"scienter" for violations involving misrepresentations and "without reasonable justification or excuse" for other violations. FSC § 1704(b)(1); see text accompanying notes 120-22 *infra*.

97 The Sec. Ex. Act is alone in referring to required reports; the Inv. Co. and Inv. Adv. Acts refer to reports filed.

98 Sec. Ex. Act §§ 15(b)(5)(A) & (b)(7), 15 U.S.C. §§ 78o(b)(5)(A) & (b)(7) (1970); Inv. Co. Act § 9(b)(1), 15 U.S.C. § 80a-9(b)(1) (1970); Inv. Adv. Act §§ 203(e)(1) & (f), 15 U.S.C. §§ 80b-3(e)(1) & (f) (1970). *See generally* 2 Loss, *supra* note 2, at 1302-03; 5 *id.* at 3362-64.

99 Statutory provisions cited at note 98 *supra*.

for another with reason to believe that the other was violating the Act or a rule thereunder with respect to that transaction.[100] NASD members and their associates are subject to Commission sanctions if they: (1) violated (not necessarily willfully) the Securities Exchange Act or any rule thereunder;[101] (2) effected a transaction for another with reason to believe the other was committing such a violation;[102] (3) willfully violated the Securities Act or any rule thereunder;[103] or (4) effected a transaction for another with reason to believe the other was committing such a willful violation.[104] The focus here will be on the interpretation of the willfully concept, which most administrative proceedings have involved.

A. *Violations Not Involving Misrepresentations*

1. Present Law: Willfully in Practice

The degree of knowledge of surrounding circumstances which is required to render an activity a willful securities law violation is of critical importance, both in the degree of culpability necessary for actionable violation and in practical effect upon the Commission's regulatory power. There is quite a range between awareness that one is or is not buying, selling or disseminating information, and awareness that one's activity violates a particular statute or rule. Unfortunately the opinions are not always clear about what is required. For example, one respondent[105] accused of manipulative activity claimed that the Commission must prove that he "had an understanding"[106] that his actions were manipulative in order to impose sanctions for willfully violating the Securities Exchange Act. The court rejected this claim as "wholly lacking in merit,"[107] going on to say that "[i]t has been uniformly held that 'willfully'

100 Sec. Ex. Act § 19(a)(3), 15 U.S.C. § 78s(a)(3) (1970). *See generally* 2 Loss, *supra* note 2, at 1172-78; 5 *id.* at 3131-43. The "reason to believe" ground appears not to require that any violation actually occur, but as a practical matter there would seldom, if ever, be "reason to believe" in the absence of a violation.

101 Sec. Ex. Act § 15A(*l*)(2)(A), 15 U.S.C. § 78o-3(*l*)(2)(A) (1970). *See generally* 2 Loss, *supra* note 2, at 1387-89; 5 *id.* at 3506.

102 Sec. Ex. Act § 15A(*l*)(2)(A), 15 U.S.C. § 78o-3(*l*)(2)(A) (1970). On the need for a violation by the other, see note 100 *supra.*

103 Sec. Ex. Act § 15A(*l*)(2)(B), 15 U.S.C. § 78o-3(*l*)(2)(B) (1970).

104 *Id.* On the need for a violation by the other, see note 100 *supra.*

105 Tager v. SEC, 344 F.2d 5 (2d Cir. 1965).

106 *Id.* at 8.

107 *Id.*

in this context means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules or Acts."[108] But awareness that conduct is manipulative and awareness of the existence of a statute or rule applicable to such conduct, much less awareness that the conduct is violative of the law, are very different states of knowledge.

Similarly, in another case the respondent denied that it had willfully violated Securities Act § 5 on the grounds that "at no time did it intend, nor was it aware that [the control-person] intended, a distribution of a large block of stock."[109] The Commission, without explicitly dealing with this contention, said that "[r]espondent knew that it was effecting a distribution for a control person and that no registration statement was in effect for the securities being distributed. Since [r]espondent was fully aware of what it was doing, its violation was willful . . . ."[110] Whether the Commission thereby rejected respondent's contention on knowledge or meant that mere awareness that it was selling securities for a control person alone sufficed is not clear.

Such cases suggest that ignorance, whether of the law, the facts or the effects of one's actions on the securities markets, does not prevent a willful violation. This notion is not without practical consequences, especially since securities salesmen generally are neither lawyers nor economists. The Commission's view that in this context the willfully concept does not require any kind of bad purpose,[111] knowledge that the conduct violates the law,[112] or knowledge of the existence of the law violated, indicates a drastic narrowing of acceptable defenses. Consistent with this philosophy has been the Commission's unwillingness to accept reliance on counsel as an indication that a violation was not willful.[113]

108 *Id.*

109 Ira Haupt & Co., 23 S.E.C. 589, 597 (1946).

110 *Id.* at 606.

111 Quinn & Co. v. SEC, 452 F.2d 943 (10th Cir. 1971), *cert. denied*, 406 U.S. 957 (1972); Capital Funds, Inc. v. SEC, 348 F.2d 582 (8th Cir. 1965); Van Alstyne, Noel & Co., 22 S.E.C. 176 (1946).

112 Tager v. SEC, 344 F.2d 5 (2d Cir. 1965); Henry Leach, 24 S.E.C. 237 (1946); Thompson Ross Securities Co., 6 S.E.C. 1111 (1940). *Cf.* Charles E. Bailey & Co., 35 S.E.C. 33 (1953).

113 James B. Wheeler, 28 S.E.C. 894 (1948); Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

Nevertheless, some violations have been held not to be willful. There appear to be two explanations for these cases in the face of the general ease with which willfulness is found. One case found that respondents had not willfully violated § 5 of the Securities Act because there was no showing that they knew or had reason to know that registration was required.[114] This holding suggests that when violation turns upon facts about the business situation which are not within the violator's control (a not uncommon situation with the registration requirement[115]), there must be evidence to establish that the violator either knew or in the exercise of reasonable care should have known the facts,[116] wholly aside from the question of knowledge of the provision of law which makes the facts relevant.[117] The second explanation is that the Commission may sometimes find violations non-willful if they seem to pose no threat to the regulatory scheme and the violator was making a good faith effort to comply with the law.[118]

In sum, the willfully concept is not meaningfully related to the state of mind of the violator in the context of administrative sanctions for violations not involving misrepresentations. To the extent that the Commission deems it important, state of mind is taken into account in determining what, if any, sanctions to impose. Taking the language of the cases seriously — and there is little to suggest it should not be — willfully in this context means no more than conscious, intentional or purposeful as opposed to unconscious or accidental physical activity.[119] The great difficulty with this interpretation is that it is virtually impossible to conceive of any activity related to the securities business which does

114 Lloyd, Miller & Co., SEC Sec. Ex. Act Release No. 7340 at 2 (June 11, 1964).

115 *E.g.*, whether one is dealing with a control person or the truthfulness of a buyer's asserted investment intent or state of domicil.

116 *See* Quinn & Co. v. SEC, 452 F.2d 943 (10th Cir. 1971), *cert. denied*, 406 U.S. 957 (1972). *Cf.* 1 Loss, *supra* note 2, at 687; 4 *id.* at 2657.

117 *But cf.* Ira Haupt & Co., 23 S.E.C. 589 (respondent's contention that it did not know of control person's intention to sell a significant block of shares to no avail without discussion of whether respondent should have known).

118 *See* Thomson & McKinnon, 35 S.E.C. 451 (1953); Halsey, Stuart & Co., 30 S.E.C. 106 (1949); Lowell Niebuhr & Co., 18 S.E.C. 471 (1945).

119 Capital Funds, Inc. v. SEC, 348 F.2d 582, 588 (8th Cir. 1965); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965); Ira Haupt & Co., 23 S.E.C. 589, 606 (1946); Van Alstyne, Noel & Co., 22 S.E.C. 176, 180 (1946); Thompson Ross Securities Co., 6 S.E.C. 1111, 1122-23 (1940). *Cf.* Petroleum Equities Corp., 36 S.E.C. 244 (1955); Charles E. Bailey & Co., 35 S.E.C. 33 (1953).

not fit that description — a person may accidentally drive his car over a cliff, but it would be rare indeed accidentally to buy or sell a security or desseminate information regarding a security. And if all securities business activity is willful, then all violations are willful, and the willfully concept is devoid of any functional meaning.

2. The Code Compared with Present Law

Under the Code, administrative sanctions could be visited upon securities industry participants[120] who violate a Code provision[121] without reasonable justification or excuse,[122] if the violation does not involve a misrepresentation or a failure to include a material fact or document required to be included in an application for registration under Part VII of the Code.

This substitute for the willfully concept — "without reasonable justification or excuse" — could not possibly materially reduce the findings required of the Commission as a predicate to imposing sanctions. The only apparent possibilities for escape from the present law's willfully concept — that facts essential to the violation were beyond the control of and unknown to the violator despite his exercise of reasonable care, and that the violation was relatively harmless and occurred despite the good faith effort of the violator to comply — could be accommodated as a reasonable excuse without any question of the strained, seemingly inconsistent interpretation which they now cause.[123] Indeed, the Code standard might put a heavier burden on the Commission than does the willfully concept, for proving that there is no reasonable justification or excuse for conduct seems more difficult than proving that the conduct was intentional. But there should be no difference as a practical matter.[124] The Commission must prove a violation in any event, and the factual context so developed would generally be viewed as making the violation unreasonable unless

120 Included are brokers, dealers, investment advisers, associates of and persons seeking to become the foregoing, exchange and NASD members, and persons serving or seeking to serve registered investment companies in certain capacities. FSC §§ 1507(a), 1511(a).

121 Unless otherwise stated references to Code provisions include provisions of the Code itself and Commission rules and orders. *See* FSC § 217A.

122 FSC §§ 1507(a)(1)(B) & (4)(B), 1511(a).

123 *See* 2 Loss, *supra* note 2, at 1310 n.87; 5 *id.* at 3372.

124 *See* FSC § 1507(a)-(d), Comment 2(b) (Tent. Draft No. 3, 1974).

the violator can show otherwise. In short, once a violation is shown, the burden of justification will fall on the violator, just as it does today.

The change from the willfully concept to "without reasonable justification or excuse" does raise a question about compliance with the Administrative Procedure Act's warning requirement, which employs the willfully concept as an exception to compliance with that requirement.[125] There has been no problem to date since both the APA and the securities laws use the willfully concept, and it has been given a very loose reading in the warning requirement context. Under the Code the burden on the Commission of establishing a violation will be at least as heavy as under present law. It is difficult to imagine reviewing courts suddenly requiring compliance with the warning requirement simply because the APA and Code wordings do not match. Taking the willfully concept in its APA clothing more seriously might pose a problem, but so would it if the Code retained the willfully concept. It is an unlikely event against which the Code can provide no insurance. But even in such an eventuality, the Commission could probably escape in cases truly demanding fast action by invoking the public interest exception also embodied in the APA warning requirement.[126]

3. The Code Evaluated

The Code's "without reasonable justification or excuse" standard provides a clearer route to the same result as the present

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125 Except in cases of willfulness or those in which public health, interest, or safety requires otherwise, the withdrawal, suspension, revocation, or annulment of a license is lawful only if, before the institution of agency proceedings therefor, the licensee has been given —

(1) notice by the agency in writing of the facts or conduct which may warrant the action; and

(2) opportunity to demonstrate or achieve compliance with all lawful requirements.

Administrative Procedure Act § 9(b), 5 U.S.C. § 558(c) (1970).

126 *See* note 125 *supra*. *Compare* 1 Loss, *supra* note 2, at 304-05 (on the Commission's ability to avoid the warning requirement in proceedings against registration statements without the benefit of the willfully concept); 5 *id.* at 3139 (on proceedings against exchange members under Sec. Ex. Act § 19(a)(3), 15 U.S.C. § 78s(a)(3) (1970), which also do not require a willful violation).

tortured construction of "willfully." Thus if the goal of codification is merely to reflect the present law, the Code proposal is superior to the willfully concept.

Closer examination in light of the availability of the rather severe sanctions of banishment from the securities business and the low- or no-culpability predicate to the imposition of sanctions which the Code envisions does not diminish the desirability of the Code standard. The public interest with which the securities business is affected[127] should suffice to create a duty on the part of all participants therein to conduct themselves consistently with that public interest; inability to produce "reasonable justification or excuse"[128] for a violation of the law would seem to indicate a violation of that duty.

Perhaps an ideal system would explicitly consider both the seriousness of the provision violated and the manner in which it was violated (mental element). But such an ideal is impossible to attain. The proposed standard does provide for an enormous range of discretion in the Commission, but that is inevitable. The scope and complexity of the federal securities laws make impossible detailed statutory provision for variations in sanctions according to variations in the offense. The length would be staggering and undoubtedly many situations would not be anticipated in advance. Moreover, shifting the burden of proof with the severity of the sanctions would be impractical because the appropriate sanction frequently cannot be determined until after the proceeding.

Fortunately, there is little indication from the Commission's forty year track record that abuse of its broad discretion to mete out administrative sanctions will be a problem. Finally, the availability of judicial review should suffice to deal with the occasional outrageous case. Aside from those, there is nothing to be done except to rely on the good offices of the Commission, as is true generally with the actions of administrative agencies.

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127 See text at notes 48-49 *supra.*

128 While the burden of proof technically might be on the Commission, it is apparent that once a violation would be shown by the Commission, the burden of justification would fall on the respondent. This result is suggested by the standard itself and is wholly consistent with present law despite the seeming burden on the Commission of proving willfulness.

B. *Violations Involving Misrepresentations*

1. Present Law: Willfully in Practice

It is helpful in analyzing violations involving misrepresentations to conceive of three paradigmatic varieties: affirmative misrepresentations, omissions to state information which render what is said a misrepresentation, and the unknowing passing on of misrepresentations originating with another. When the misrepresentation, whether of the affirmative or omission type, originates with the respondent the familiar litany[129] that willfulness merely requires conscious action is repeated again.[130] Culpability is both great and obvious with the outright lie, and the liar can count on a fast exit from the securities business if the Commission catches him.[131] But many adjudicated misrepresentations, particularly of the omission type, are much less egregious, and the continuum of culpability reaches down to the negligible point.[132] Plainly, failure to

129 See text accompanying notes 105-113 & 119 *supra.*

130 Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949); Van Alstyne, Noel & Co., 33 S.E.C. 311 (1952), *modified,* 34 S.E.C. 593 (1953); Moore & Co., 32 S.E.C. 191 (1951); Scott McIntyre & Co., 11 S.E.C. 442 (1942); Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

131 *Cf.* First Anchorage Corp., 34 S.E.C. 299 (1952); Scott McIntyre & Co., 11 S.E.C. 442 (1942).

132 *Compare* Thompson Ross Securities Co., 6 S.E.C. 1111 (1940) *with* Halsey, Stuart & Co., 30 S.E.C. 106 (1949) *and* Van Alstyne, Noel & Co., 33 S.E.C. 311 (1952), *modified,* 34 S.E.C. 593 (1953).

In *Thompson Ross* respondent broker-dealer sold shares for control persons under an agreement whereby 60% of the outstanding stock was placed in escrow for a period of time and willfully violated Securities Act § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1970) by representing to potential buyers that the shares it was selling were being sold at the market price.

The respondent in *Halsey,* underwriting syndicate manager of a bond issue, bought bonds in the dealer market from other syndicate members both before and after termination of the syndicate and willfully violated several provisions by failing to disclose to public customers to whom it sold bonds that its dealer market purchases raised prices, when it "knew or should have known of the tendency of its transactions to support the market and to raise prices, thus facilitating the profitable or loss-free disposition of its inventory." 30 S.E.C. at 126.

In *Van Alstyne* respondent, a significant investor in a corporation for which it was also underwriter, continually recommended purchase of the corporation's stock, emphasizing its future prospects but saying nothing of its continually dismal operating results and willfully violated several provisions by not disclosing the adverse information in its possession. Despite respondent's belief that the information was confidential and its belief in the truthfulness of the rosy predictions, as evidenced by the losses incurred by respondent and a principal officer therein, the Commission held that the "course of conduct, of making optimistic statements without disclosing the adverse information which it did not consider itself free to reveal, was embarked on knowingly, and was therefore willful." 33 S.E.C. at 339.

to disclose what should be disclosed constitutes a misrepresentation. The approach is implicitly duty of care oriented.

Cases of misrepresentations originating with someone else but passed on by the respondent have posed a bit more difficulty, just as have the non-misrepresentation cases in which the facts are beyond the respondent's control.[133] Such cases frequently arise when selling literature, at least the contents of which originated with the issuer, is distributed to the public by a broker-dealer.[134] It may safely be said regarding the applicability of administrative sanctions to persons passing on misrepresentations that the presence of a misrepresentation does not alone suffice,[135] but that such a person need not know of the misrepresentation,[136] the question being whether he should have known.[137] Left in doubt is the standard of care — the degree of neglect in checking the accuracy of the representations — which will constitute willfulness. The cases seldom contain a square holding on this matter; finding reckless conduct, for example, to suffice does not necessarily imply that negligence would not. And there are seeming inconsistencies among what intimations are found in the cases. One very early case squarely holds that negligence is not enough;[138] another seems to hold that it is.[139] Other standards suggested by the cases are gross recklessness,[140] recklessness,[141] gross carelessness and indifference,[142] and careless disregard.[143] There is, of course, considerable question whether and to what extent the differences are other than semantic. Certainly, deviation from accepted industry norms in scrutinizing representations is risky and perhaps the Commission is able here,

133 See text accompanying notes 114-118 *supra.*

134 *E.g.*, Edgerton, Wykoff & Co., 36 S.E.C. 583 (1955); Charles E. Bailey & Co., 35 S.E.C. 33 (1955); Foreman & Co., Inc., 3 S.E.C. 132 (1938).

135 *See* Edgerton, Wykoff & Co., 36 S.E.C. 583, 589 (1955) (no violation); J. Robert Lindsay & Co., 35 S.E.C. 57, 59-60 (1953) (non-willful violation).

136 *See* Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967); Charles E. Bailey & Co., 35 S.E.C. 33, 41-43 (1953).

137 *See, e.g.*, Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967); Henry P. Rosenfeld, 32 S.E.C. 731, 739-40 (1951).

138 Foreman & Co., Inc., 3 S.E.C. 132, 138 (1938).

139 Charles E. Bailey & Co., 35 S.E.C. 33, 42 (1953).

140 Henry P. Rosenfeld, 32 S.E.C. 731, 739 (1951).

141 First Anchorage Corp., 34 S.E.C. 299, 304 (1952); Foreman & Co., Inc., 3 S.E.C. 132, 141 (1938).

142 J. Robert Lindsay & Co., 35 S.E.C. 57, 59-60 (1953); Foreman & Co., Inc., 3 S.E.C. 132, 135 (1938).

143 Foreman & Co., Inc., 3 S.E.C. 132, 135 (1938).

as in other applications of the willfully concept, to set whatever standard it deems desirable.

These cases leave no doubt that, as with other violations, the willfully concept is not much of a hurdle for the Commission to jump before imposing administrative sanctions for misrepresentations. No element of bad purpose[144] is required, nor is knowledge of the provision violated necessary.[145] If a person is in possession of the facts which constitute the violation, honest belief that his actions are perfectly proper[146] or at least within the letter of the law[147] is irrelevant, and the Commission will brook no challenge to its preliminary interpretation of the law.[148] Advice of counsel is thus irrelevant.

Emasculation of the willfully concept then is not the striking aspect of the treatment of violations involving misrepresentations. What stands out is the duty of care approach taken by the Commission. Outright lies are willful by any standard and a duty of care approach is unnecessary. But failures to disclose information and failures to discover the falsity of information being passed on often may not be willful in any meaningful sense but may be more akin to negligent conduct, and that is the tack interpretation of the willfully concept has taken in the context of administrative sanctions for violations involving misrepresentations. The critical question is not so much whether a misrepresentation was deliberate as whether the respondent should have known. And, of course, the Commission provides the answer.

2. The Code Compared with Present Law

A trip down the trail from the appearance of a misrepresentation to the application of sanctions is perhaps the best route to an understanding of the Code scheme of administrative sanctions and

144 *See* Jack Goldberg, 10 S.E.C. 975, 981 (1942); Foreman & Co., Inc., 3 S.E.C. 132, 135 (1938).

145 *See* Henry P. Rosenfeld, 32 S.E.C. 731 (1951); Scott McIntyre & Co., 11 S.E.C. 442, 446 (1942); Thompson Ross Securities Co., 6 S.E.C. 1111, 1122-23 (1940).

146 *See* Van Alstyne, Noel & Co., 33 S.E.C. 311, 339 (1952), *modified*, 34 S.E.C. 593 (1953); Moore & Co., 32 S.E.C. 191, 197 (1951).

147 *See* Hughes v. SEC, 174 F.2d 969, 976-77 (D.C. Cir. 1949); Jack Goldberg, 10 S.E.C. 975 (1942).

148 *See* Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949); Halsey, Stuart & Co., 30 S.E.C. 106 (1949).

its relation to present law. Under the Code, administrative sanctions may be applied only to one who both makes a misrepresentation, and makes it with "scienter."

Misrepresentation status can be attained by "(1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made."[149] Even if the foregoing criteria are met, escape may be had if the statement made is (1) made in good faith, and (2) reasonably based on facts when made, "including whatever investigation is appropriate under the circumstances," and (3) in compliance with any applicable rule.[150] Deliberate attempts to mislead, whether affirmative misstatements or omissions, would all be misrepresentations, for they would inevitably fail the good faith test. All candidates presently caught by the Commission's duty of care approach could be caught by the second of the three tests. Omissions which should not (according to the Commission) have been made would be caught, for whatever statement was made would not have been "reasonably based on facts" when made. The same fate would befall the rare if not non-existent affirmative misstatement originated in good faith by the respondent. Misstatements originating elsewhere but passed on by the respondent, to which the duty of care approach has been most explicitly applied under present law,[151] would also be nabbed for failure of the respondent to make "whatever investigation is appropriate under the circumstances."

The next stage of the trial is the "scienter" concept, the Code predicate to the imposition of both criminal and administrative sanctions for violations involving misrepresentations.[152]

149 FSC § 259(a).

150 *Id.* § 259(b).

151 See text accompanying notes 133-143 *supra.*

152 FSC §§ 1507(a)(4)(A), 1511(a). This change to scienter is part of a change in approach to the whole problem of misrepresentations — or fraudulent and manipulative acts, as Part XIII (§§ 1301-11) of the Code is labeled. The Code includes sections that define, in addition to scienter, all the other important terms involved — misrepresentation (§ 259), fraudulent act (§ 234D), knowledge (§ 251A), fact (§ 234A), material (§ 256), and caused (§ 215A). Under the Code scheme provisions proscribing unlawful conduct do so without mention of culpability. The culpability requirement is found in the provisions on the justifications for administrative and criminal sanctions. FSC § 259, Comment 3(c) (Tent. Draft No. 2, 1973).

> A person makes . . . a misrepresentation with "scienter" if he (a) knows that the matter is otherwise than as represented, (b) does not have the confidence in its existence or nonexistence that his representation expresses or implies, or (c) knows that he does not have the basis for his representation that it expresses or implies.[153]

Scienter does not lend itself particularly well to the duty of care approach presently employed on the administrative side. The first clause is aimed at knowing misrepresentation;[154] ignorance would remove one from its grasp. The second clause would be helpful to the extent that the respondent's protestations of confidence were disbelieved. While it does not apply a wholly external standard (for the respondent may indeed have had the confidence which would take him out of reach even if no reasonable man would be so confident[155]), it would no doubt go a long way toward the present standard in practice. The third clause turns on the respondent's knowledge, which again is internal and therefore potentially avoidable. But circumstantial evidence could be used to establish the respondent's belief as to what the recipient of the representation took it to imply notwithstanding his protestations.[156] Thus it appears that the Code approach, while not well adapted to what the Commission seems to be doing on the administrative side, probably could be stretched to reach most of the conduct which the Commission presently reaches.[157]

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153 FSC § 296AA.

154 The Comment indicated that belief in the falsity of the representation also suffices. FSC § 251A, Comment 3 (Tent. Draft No. 2, 1973).

155 This case would also seem to be unreachable by means of the "expresses or implies" clause because the confidence in his representation is still internal.

156 A respondent may not realize "how much" he implies but would know that he didn't have "that much" basis. The Comment, however, suggests at first glance a much narrower scope for the third clause: "the defendant who is honestly convinced of the truth of the statement, whether from hearsay or from other sources that he believes to be reliable, but knows that the person with whom he is dealing will assume that he has a different and clearly more reliable source for his belief." FSC § 251A, Comment 3 (Tent. Draft No. 2, 1973). Query what respondents would "know" about others' assumptions about sources. But this might be a roundabout way back to today's more or less "reasonable man" standard — the respondent will be taken to know what a reasonable person would expect in light of his representation, and failure to meet the standard of investigation implied by that expectation would bring the respondent within the third clause. Perhaps a classic example would be a buy or sell recommendation based upon brokerage community rumors regarding expected corporate activity which turn out to be wholly unfounded. *See* First Anchorage Corp., 34 S.E.C. 299, 302 (1952).

157 The Commission is also protected by § 1515(a), which would allow it to obtain

3. The Code Evaluated

The willfully concept is wisely abandoned, for willfulness is quite unrelated to the duty of care approach followed in practice and misrepresentations which are realistically labelled willful certainly would also fail the duty of care tests. As will be seen,[158] the scienter standard is a big improvement on the criminal side. For purposes of administrative sanctions, however, there is reason to doubt the wisdom of using the scienter standard.

The Code formulation poses no problems so far as deliberate misrepresentation, whether of the affirmative or omission variety, are concerned. A lie, after all, is a lie. The mental state of the liar is sufficiently damnable to warrant sanctions if the potential injury is severe. Slight twinges of doubt set in, however, when the black and white realm of deliberate misrepresentations is left behind for the various shades of gray, particularly those in which the respondent or defendant is a conduit for misrepresentations originated by another.

Use of scienter in both the criminal and administrative contexts parallels the present dual use of willfully. Since it may well be desirable to impose administrative sanctions in cases where criminal sanctions would be thought inappropriate, one is faced with the unpleasant choices of underinclusion on the administrative side, overinclusion on the criminal side, or (as with willfully now) a confusing and perhaps unsuccessful attempt to give scienter different meanings in each of the two contexts.

Perhaps one ought first to ask whether the scienter predicate is necessary at all on the administrative side. It can perform a useful function only if the Code definition of misrepresentation includes some conduct which should not result in sanctions. Reference to the definition of misrepresentation suggests that overinclusion is not much of a problem. Misstatements or omissions failing the good faith test for escape from misrepresentation status[159] would

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an injunction against further misrepresentations without a showing of scienter. It could then proceed against the violator without more under § 1507(a)(3). Of course, a finding of the likelihood of further violation required by § 1515(a) is a virtual guarantee that scienter is present, but the absence of an explicit need to prove it is insurance against the unlikely possibility that the scienter standard might otherwise prevent the Commission from acting in some meritorious case.

158 See part IV. B. *infra.*

159 FSC § 259(b)(1).

appear to be deserving of administrative sanctions. The same would appear to be true of those which are made without reasonable basis in fact[160] or after failure to make an adequate investigation;[161] indeed, such appear to be the very standards which are imposed today in practice. Failure to comply with a Commission rule,[162] while it usually would justify the imposition of administrative sanctions, presumably would not in some circumstances. To the extent that one could violate a Commission rule in good faith, the present definition would appear to be overinclusive.

Scienter may not be the best device for eliminating overinclusion on the administrative side, however. The subjective knowledge orientation of the scienter standard is not well adapted to the more objective duty of care approach now in use. While the standard might be bent to give a reach comparable to present practice, that is problematical, and would in any event be awkward. Moreover, such bending would not solve the problem of overinclusion with respect to criminal sanctions.

Nevertheless, scienter should not simply be dropped without replacement on the administrative side. There is not only the slight problem of overinclusion, but also the fact that the definition of misrepresentation will see duty in a number of contexts — civil liability, administrative and criminal sanctions. Since there are sure to be differing considerations involved in the imposition of the various types of liability, it seems wise to separate entirely the predicates for their imposition from the definition of misrepresentation common to all of them. In that way, the development of separate, coherent lines of precedents for the definition and for the predicates would be facilitated.

One alternative to scienter on the administrative side is the standard proposed by the Code as the predicate to administrative sanctions for violations not involving misrepresentations — "without reasonable justification or excuse."[163] Use of that standard would remedy the problem of overinclusion by leaving open the possibility that there might have been reasonable justification or

160 *Id.* § 259(b)(2).
161 *Id.*
162 *Id.* § 259(b)(3).
163 *Id.* § 1507(a)(4)(B).

excuse for a misrepresentation, and hence that the imposition of sanctions would be inappropriate. It would maintain the conceptual separation between the definition of misrepresentation and the predicate for imposition of sanctions. It would separate the administrative from the criminal situations, avoiding one of the problems of the willfully concept. Use of a uniform predicate to all administrative sanctions would prevent the development (now possible in the Code) of different culpability requirements in the punishing of misrepresentation and non-misrepresentation violations. The "without reasonable justification or excuse" standard would also leave the Commission flexibility, for what is reasonable obviously may vary with the surrounding circumstances.[164]

The proposed standard does lack the apparent relation to paradigmatic cases of fraud and misrepresentation which the scienter concept exhibits. But the Code definition of misrepresentation is broader than the paradigm. And there is no doubt that there would be no reasonable justification or excuse for a misrepresentation made with scienter.

Finally, the "without reasonable justification or excuse" standard would facilitate continuation of the present duty of care approach to sanctions for violations involving missrepresentations. The nub of the matter would appear to be whether that is desirable. The Code seems not to recognize the duty of care approach, rather than to advocate abandonment of it.[165] The preventive role of the Commission suggests the desirability of continuing the duty of care approach just as it does with administrative sanctions for non-misrepresentation violations. This is particularly true of misrepresentations which are merely passed on by the respondent. A scienter standard focused on the respondent's knowledge of a misrepresentation might enable securities industry respondents to escape sanctions by pointing to the issuer (or other source of the misrepresentation), against whom only criminal sanctions may be available. The greater accessibility and flexibility of administrative action suggest that would be an unfortunate result. However, the decisive consideration in favor of the duty of care orientation is the reasonableness of requiring securities industry participants, on

164 *See* FSC § 1507(a)-(d), Comment 6(a)(iv) (Tent. Draft No. 3, 1974).
165 *Id.*

pain of administrative sanctions, to make some effort to determine the accuracy of the information they pass on to induce investors to part with their money. The degree of investigation of course would vary with the circumstances.[166]

IV. Criminal Sanctions

Unlike the highly varied and inconsistent administrative provisions, the present criminal provisions all use the willfully concept as a predicate to the imposition of criminal sanctions. All six of the acts make willful violation of the act or rules thereunder criminal,[167] and all deal with misstatements or omissions of material facts in various filings made under the acts.[168] As with the discussion of administrative sanctions above, it is useful to divide the analysis into criminal violations involving and not involving misrepresentations.

A. *Violations Not Involving Misrepresentations*

1. Present Law: Willfully in Practice

Divining the content of the willfully concept is perhaps most difficult with respect to criminal violations not involving misrepre-

166 *See* FSC § 259(b), Comment 3 (Tent. Draft No. 2, 1973).

167 *See* note 17 *supra*. All but the Sec. and Sec. Ex. Acts also make willful violation of Commission orders criminal. The Sec. Ex. Act limits criminal sanctions for violations of rules to those "the violation of which is made unlawful or the observance of which is required under the terms of this title." The Sec. Ex. and Hold. Co. Acts specify that the willful violation of a few specific sections, unimportant here, is not criminal. The Hold. Co. Act also makes willful destruction of certain records criminal.

In addition, the unlawful and willful conversion of registered investment company assets is a crime. Inv. Co. Act § 37, 15 U.S.C. § 80a-36 (1970). The Code adopts a Code-wide theft provision (for both criminal and administrative purposes) that deletes any reference to the willfully concept. FSC §§ 1517(c), 1507(a)(4), (c). Instead theft is defined by reference to the proposed new Federal Criminal Code, which will contain its own provisions on culpability, making reference to culpability in the Federal Securities Code unnecessary in this instance.

168 Four cover omissions explicitly. Sec. Act § 24, 15 U.S.C. § 77x (1970); Trust Ind. Act § 325, 15 U.S.C. § 77yyy (1970); Inv. Co. Act § 49, 15 U.S.C. § 80a-48 (1970); Inv. Adv. Act § 217, 15 U.S.C. § 80b-17 (1970). Two do not but clearly encompass omissions by referring to false or misleading statements. Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970); Hold. Co. Act § 29, 15 U.S.C. § 79z-3 (1970). All except the Sec. Ex. Act proscribed such statements when made willfully; under that Act, they must be made willfully and knowingly.

sentations. Prosecutions for violations of the registration provision of the Securities Act[169] have been the most common among the rather limited number of cases considering the willfully concept in the criminal, non-misrepresentation context. Convictions following a jury instruction that willfulness requires contemporaneous knowledge that the conduct is unlawful have been affirmed,[170] but that establishes little. However, the favorable characterizations given in some opinions to the government's contrary position — that willfully does not require knowledge that the alleged activity is unlawful — suggest that no consistent position has been adopted.[171] Other opinions are so cryptic as to be of no use at all.[172] For years the only precedent in point[173] was a district court opinion denying a motion for a new trial by the trial judge, who not surprisingly upheld his own charge on willfulness,[174] a slender reed on which to rest the proposition that willfully has the same vapid meaning in the criminal as in the administrative context.

Some courts have tended to downplay the willfully concept when the defendants were cognizant of all the facts necessary to establish liability, except perhaps the law and its applicability to them.[175] The conscious action construction of willfully which has found favor in the more numerous opinions on the administrative side is easily adopted when, for example, a defendant sells unregistered securities for an issuer. Such sales are made prima facie unlawful by the basic provision of the Securities Act; knowledge of the Act's existence, surely not too much to expect of persons (especially securities professionals) involved in securities distributions, is a red flag to those involved.

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169 Sec. Act § 5, 15 U.S.C. § 77e (1970).

170 Tarvestad v. United States, 418 F.2d 1043, 1047 (8th Cir. 1969), *cert. denied*, 397 U.S. 935 (1970). United States v. Dardi, 330 F.2d 316, 331, n.6 (2d Cir. 1964); Roe v. United States, 316 F.2d 617, 621 n.9 (5th Cir. 1963).

171 Roe v. United States, 287 F.2d 435, 441-42 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961); United States v. Custer Channel Wing Corp., 247 F. Supp. 481, 490 (D. Md. 1965), *aff'd*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967).

172 *See* United States v. Wolfson (Continental Enterprises), 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); United States v. Robertson, 298 F.2d 739 (2d Cir. 1962).

173 5 Loss, *supra* note 2, at 3367.

174 United States v. Sussman, 37 F. Supp. 294, 296 (E.D. Pa. 1941).

175 United States v. Schwartz, 464 F.2d 499, 509-10 (2d Cir.), *cert. denied*, 409 U.S. 1009 (1972). *See* United States v. Sussman, 37 F. Supp. 294, 296 (E.D. Pa. 1941).

Doubts about the applicability of the administrative construction of willfully arise, however, when the focus shifts to situations in which either the law is unclear or the facts essential to a violation may not be known to the violator. The leading case on willfully in the criminal context is *United States v. Crosby*.[176] The convictions of the broker-dealer defendants for conspiracy and selling unregistered stock were reversed for insufficient evidence. The opinion does not fully separate discussions of the conspiracy and unregistered sale of stock convictions. The broker-dealers had sold for a control person knowing that the stock was unregistered, so the case at least holds that mere knowledge that the shares are unregistered is not enough to sustain a conviction when a defendant is selling for a control person. Beyond that a number of interpretations are possible: that conviction requires proof that defendants knew (or should have known) the facts, were (or should have been) aware of the law,[177] knew (or should have known) that they were underwriters, or that the defendants acted with specific intent to violate the law (which the opinion does require for conspiracy).

One commentator has suggested that *Crosby* requires "that the Government need not prove *actual* knowledge of the specific illegality, *i.e.*, a bad purpose or a specific criminal intent, but rather 'willfulness', *i.e.*, a general criminal intent."[178] That, however, merely restates the problem in slightly different terms, requiring courts to distinguish between a general and a specific criminal intent. Probably the best view is that *Crosby* requires proof of actual knowledge of the facts which create liability when the law is applied to them, *e.g.*, that a broker-dealer know the facts which make the person for whom he is selling stock a control person in the eyes of the law.[179] Knowledge of the law and hence an

176 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962), *discussed in* 5 Loss, *supra* note 2, at 3369-70, 3371-72.

177 *See* Tarvestad v. United States, 418 F.2d 1043 (8th Cir. 1969), *cert. denied*, 397 U.S. 935 (1970).

178 Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 Geo. Wash. L. Rev. 901, 952 (1971).

179 *See* United States v. Dardi, 330 F.2d 316, 331 (2d Cir. 1964); United States v. Hill, 298 F. Supp. 1221, 1234 (D. Conn. 1969); United States v. Custer Channel Wing Corp., 247 F. Supp. 481, 495 (D. Md. 1965); 5 Loss, *supra* note 2, at 3371-72. *But see* Mathews, *supra* note 178, at 952 n.296.

appreciation of the relevance of the facts would seem not to be required, but as a practical matter it is difficult to imagine (at least in the *Crosby* context) total ignorance of the law on the part of a person involved in a securities distribution of sufficient magnitude to invoke it.

This confusing state of affairs is easier to explain than to resolve. At the bottom is the simple fact that there is nothing inherently evil in performing (or failing to perform) the proscribed (or commanded) acts, at least absent knowledge of the law's requirements,[180] and always assuming that no misrepresentation is involved. The inherently innocuous nature of the proscribed activity makes the degree of defendant's knowledge of the law an important element in the degree of culpability involved in violation thereof. Since there is natural hesitation to impose criminal liability without fault, one would expect some pressure in the direction of construing the concept to include some degree of awareness approaching knowledge that the conduct is unlawful, or at least of the existence of the provision violated.

The confusion is not lessened by the statutes themselves, for despite the repeated use of willfully, there are some differences among the statutes regarding the importance of knowledge in sustaining conviction and imprisonment. Violations of rules or orders under the Investment Company and Holding Company Acts are not criminal if the defendant can prove that he did not know of the rule or order violated;[181] the necessary implication is that knowledge of a statutory provision violated is not required for conviction under those acts. The Securities Exchange Act is a bit less generous, providing that a person cannot be imprisoned (the ineluctable implication being that he can be convicted and fined) for violating a rule if he proves that he had no knowledge of the rule.[182] The same conclusion is compelled by the provision

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180 See text accompanying notes 233-34 *infra*.

181 Inv. Co. Act § 49, 15 U.S.C. § 80a-48 (1970); Hold. Co. Act § 29, 15 U.S.C. § 79z-3 (1970).

182 Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970). In United States v. Peltz, 433 F.2d 48 (2d Cir. 1970), defendant customer gave his broker a sell order, saying he owned the number of shares to be sold when in fact he did not own the stock. The broker, unaware that the transaction was a short sale, inadvertently violated the Commission's down-tick rule on the selling price in short sales (17 C.F.R. § 240.10a-1(a) (1974)). The cusotmer's conviction for violation of the down-tick rule was upheld

of that statute making certain materially false or misleading statements criminal only if made willfully *and* knowingly, while using only willfully to describe the mental element required for other criminal violations.[183] The Securities,[184] Trust Indenture[185] and Investment Advisers[186] Acts simply use the unvarnished willfully concept. Knowledge of the provision violated appears not to be a prerequisite to conviction under any of the acts today with the exception of violation of rules and orders under the Holding Company[187] and Investment Company[188] Acts.

Both the prima facie moral neutrality of the conduct giving rise to non-misrepresentation securities law violations and the detailed complexity of those laws make reliance on the advice of counsel another troubling factor. *United States v. Crosby*[189] does contain language suggesting that good faith reliance on advice of counsel may negate willfulness and hence criminality,[190] although the passage may refer to the conspiracy rather than the Securities Act charge. The better reading of *Crosby* seems to be that reversal turned upon the defendants' ignorance that they were dealing with a control person, not on a good faith defense based upon reliance on advice of counsel.[191] Other cases have suggested that advice of counsel is irrelevant because it is a factor only when specific intent is required for criminality, which is said not to be the case with non-misrepresentation violations of the securities laws.[192]

Uncertainty over the appropriate approach to culpability is heightened because the Supreme Court has never pronounced

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on appeal, the court finding it sufficient that the defendant knew he was doing a wrongful act (the lie to his broker), that the act was wrongful under the securities laws (the lie resulted in a conviction for violation of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974)), and "that the knowingly wrongful act involve[s] a significant risk of effecting the violation that has occurred" (the broker's violation of the down-tick rule). 433 F.2d at 55.

183 Sec. Ex. Act § 32, 15 U.S.C. § 78ff (1970).

184 § 24, 15 U.S.C. § 77x (1970).

185 § 325, 15 U.S.C. § 77yyy (1970).

186 § 217, 15 U.S.C. § 80b-17 (1970).

187 § 29, 15 U.S.C. § 79z-3 (1970).

188 § 49, 15 U.S.C. § 80a-48 (1970).

189 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962).

190 *Id.* at 942.

191 *See* text accompanying notes 176-179 *supra*. *Cf.* United States v. Dardi, 330 F.2d 316, 326 (2d Cir. 1964).

192 United States v. Hill, 298 F. Supp. 1221, 1234-36 (D. Conn. 1969); United States v. Custer Channel Wing Corp., 247 F. Supp. 481, 495 (D. Md. 1965).

upon the willfully concept in the securities law context. The absence of a Supreme Court precedent is particularly important in the criminal non-misrepresentation field, where the severity of a felony conviction may attach to a low- or no-culpability public welfare offense. The leading precedent on culpability,[193] which came down in favor of a bad purpose requirement, is easily distinguishable on its facts. It required a bad purpose where none was stated. The crime, however, was of common law origin, where such intent was universally required, so the Court could easily impute a bad purpose requirement. The securities laws are quite different, and are included by the Court in its list of "dangerous" products to which low- or no-culpability public welfare legislation is appropriate.[194] On the other hand, the Court mentions the willfully concept as used to denote guilty knowledge and notes that public welfare offenses generally carry minor sanctions.[195] The severity of the sanctions for securities law violations suggests that perhaps the Court would opt for a bad purpose construction.

Support for a bad purpose construction is also found in early and apparently thorough studies of the legislative history of the Securities[196] and Securities Exchange[197] Acts. However, the virtually meaningless construction given willfully on the administrative side[198] and the element of scienter which seems to be present in willfully for criminal misrepresentation purposes[199] can only add to the confusion over the meaning of willfully in the criminal non-misrepresentation context.

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193 Morissette v. United States, 342 U.S. 246 (1952).

194 *Id.* at 254.

195 *Id.* at 252.

196 "The element of 'willfulness' seems to have been the only aspect of criminal liability which, according to the transcript of hearings, received any extended discussion by the Congressional Committees. The repeated discussion of that requirement by the Committees shows how concerned they were to restrict the liability to cases of intentional violations." Herlands, *Criminal Law Aspects of the Securities Act of 1933*, 67 U.S.L. REV. 562, 565-66 (1933).

197 "The express requirement of 'willfulness' in § 32 and the seriousness of the possible penalty thereunder warrant the belief that 'guilty intent' will be required for prosecutions under this statute. . . . And such was the definition which the Congressional Committees intended the word to have in the present legislation." Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 147-48 (1934).

198 See parts III. A. 1. and B. 1. *supra*.

199 See part IV. B. 1. *infra*.

2. The Code Compared with Present Law

The Code replaces willfully with "intentionally"[200] or "recklessly"[201] as predicates to criminal sanctions for non-misrepresentation violations. A person violates " 'intentionally' if, when he engages in conduct of the specified kind, (i) it is his purpose to do so or to cause the specified result, and (ii) he knows that the attendant circumstances that are specified exist . . . ."[202] A person violates " 'recklessly' if (i) he engages in the conduct in conscious and clearly unjustifiable disregard of a substantial likelihood of the existence of the relevant facts or risks, and (ii) his disregard involves a gross deviation from acceptable standards of conduct."[203] "Knows" includes "awareness by a person of a high probability of the existence or nonexistence of a particular fact, unless he actually believes the contrary."[204]

There is little doubt that the Code provisions will be as effective in nabbing evil-doers as the willfully concept. As has been previously noted, the conduct regulated by the securities laws is virtually always intentional.[205] Thus it may be expected that all relevant conduct will be covered by the "intentionally" standard unless the defendant does not know "that the attendant circumstances that are specified exist."[206] The meaning of that phrase is not entirely clear. It certainly does not refer to knowledge of the law.[207] Probably it refers to all factual elements in the business situation which are relevant to the determination that a violation of the Code has occurred. If such is the case, the standard would be similar to the suggested interpretation of *United States v. Crosby*.[208] The "recklessly" standard apparently is meant to, and no doubt could be construed to, prevent persons from ignoring the obvious or failing to investigate when the obvious facts are a red flag. Thus, a person who was genuinely fooled by another with

200 FSC §§ 1517(a)(1) & (2).
201 *Id.*
202 *Id.* § 1517(b)(1)(A).
203 *Id.* § 1517(b)(1)(B).
204 *Id.* § 251A.
205 See text following note 119 *supra.*
206 FSC § 1517(b)(1)(A)(ii).
207 *See id.* § 1517(b)(2).
208 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962). *See* text accompanying notes 176-179 *supra.*

respect to the factual situation, or who made at least a minimal effort to investigate the facts, would be beyond the reach of criminal sanctions. *Crosby* suggests that is the law today so the Code may simply clarify rather than change the law. Certainly it is not a radical departure.

The Code position regarding knowledge of the law by the violator — that knowledge is not required for intentional or reckless violation,[209] but that imprisonment is barred "for violation of a rule or order that is not a violation of this Code apart from the rule or order if the court is satisfied that [the defendant] was not aware of the rule or order"[210] — is a reasonable resolution of the inconsistent pattern of the present provisions. Conviction avoidance on grounds of ignorance is made difficult, if not impossible. While knowledge of the provision violated is not required for intentional or reckless violation, it may be part of the totality of circumstances considered in determining whether a defendant's conduct should be labelled intentional or reckless. But that is the position on knowledge which apparently has prevailed to date under present law,[211] with the exception of the explicitly contrary statutory provisions that demonstrated ignorance bars conviction for violation of a rule or order under the Investment Company[212] and Holding Company[213] Acts.

The Code imprisonment avoidance provision also appears to be an intermediate position. The poles of present law range from no avoidance provision at all to avoidance of conviction, let alone imprisonment, if the defendant can prove his ignorance.[214] The Code mitigates the burden on the defendant by changing from proof by the defendant to satisfaction of the court that the defendant was ignorant of the law,[215] apparently giving the court a large measure of discretion to make inferences from the circumstances. But the Code's avoidance provision applies only to violations of rules and orders that are not "apart from the rule or order

209 FSC § 1517(b)(2).
210 *Id.* § 1517(a)(3).
211 See text accompanying notes 181-88 *supra.*
212 § 49, 15 U.S.C. § 80a-48 (1970).
213 § 29, 15 U.S.C. § 79z-3 (1970).
214 See text accompanying notes 181-88 *supra.*
215 FSC § 1517(a)(3).

a violation of this Code"[216] which, a Comment explains, refers to rules and orders adopted under statutory provisions which do not themselves proscribe the specified conduct.[217] The existing provisions seemingly apply to all violations of rules and orders. Moreover, it is significant that the Code considerably widens the scope of the criminal provisions, for the violation of orders under the Securities[218] and Securities Exchange[219] Acts is not criminal and the Commission's power to make rules and orders is broader under the Code than under present law.[220]

The Code's modest announcement that "advice of counsel is relevant but not conclusive in determining whether a person violates intentionally or recklessly"[221] comes against a background of complete silence in the present statutes and utter confusion in the cases and commentary. The Code provision does nothing to abate the confusion when read in conjunction with the intentionally and recklessly predicates to criminality and the disclaimer of the need for knowledge of the provision violated. It has been suggested above[222] that the standard imported by these provisions is knowledge or reckless ignorance by the defendant of all the facts necessary to characterize his conduct as violative of the Code. But advice of counsel would be irrelevant under such a standard, for counsel advises on the law, not on the facts. Since advice of counsel is explicitly made relevant, the relationship between the culpability predicates to criminal sanctions and the defendant's knowledge of the law becomes more complex than heretofore suggested. It appears that advice of counsel, defendant's knowledge of the provision, and the question of intentional or reckless conduct are to be mushed together for jury determination. Nobody knows whether making advice of counsel "relevant but not conclusive" changes the law.[223] If it does, the change would be minimal, saving

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216 FSC § 1517(a)(3).
217 FSC § 1517(a), Comment 5(d)(i) (Tent. Draft No. 3, 1974).
218 *See* § 24, 15 U.S.C. § 77x (1970).
219 *See* § 32, 15 U.S.C. § 78ff (1970).
220 *See* FSC § 1502; FSC § 1517(a), Comment 5(d)(i) (Tent. Draft No. 3, 1974).
221 FSC § 1517(b)(3).
222 See text accompanying notes 206-08 *supra.*
223 *But see* Note, *Reliance on Advice of Counsel,* 70 YALE L.J. 978, 991-92 (1961) (courts have tended to construe statutes employing the willfully concept as leaving no room for advice of counsel).

from conviction some few defendants who acted on counsel's advice that their conduct was lawful only to find out that it was not.

3. The Code Evaluated

The Code's abandonment of willfully for the elaborately defined constructs "intentionally" and "recklessly" is to be applauded. The paucity of judicial decisions and the indecisive judicial posture regarding the meaning of willfully indicate that the precedential value of the willfully concept is minimal at best. Use of the concept in both the administrative and criminal provisions of the present law, with the attendant confusion over whether it imports a higher degree of culpability in the latter, has added to the existing confusion and the desirability of making a clean break in the Code. The soundness of the decision is further indicated by the slight differences in the present statutory criminal provisions, which suggest the possibility that willfully has different meanings within the criminal provisions of present law.[224] One purpose of the Code is to iron out such illogical differences.

Nevertheless, there may be room for improvement of the Code's provisions, for they raise a number of questions in two broad areas: first, the appropriateness of the intentionally and recklessly standards, since virtually all conduct with which the Code is concerned is intentional; second, the appropriateness of the Code provisions on knowledge and advice of counsel in light of the public welfare nature of nonmisrepresentation violations of the federal securities laws.

The intentionally and recklessly standards track the proposed new Federal Criminal Code and the expressed intention of the Reporter is to adopt whatever language eventuates there.[225] Of course, there is much to be said for such a borrowing;[226] but the Code already is intended to depart from the proposed Federal Criminal Code by using the scienter concept as the predicate to criminal sanctions for violations involving misrepresentations.[227] That is an excellent choice for the Code, and there may be reason

224 See text accompanying notes 181-88 *supra*.

225 *See* FSC § 1507(a)-(d), Comment 6(a)(4) (Tent. Draft No. 3, 1974).

226 *See generally* BROWN COMM'N REPORT, *supra* note 19, at § 302; Weinreb, *supra* note 19.

227 See part IV. B. *infra*.

too for similar deviation with respect to non-misrepresentation criminal violations. A final answer would require careful analysis of the entire Code, which is beyond the scope of this article. However, there are indications that some tinkering with the standards may be in order.

While the intentionally standard is basically sound, the recklessly standard[228] is of dubious desirability. The conduct with which the general criminal law will be most concerned bears little resemblance to the conduct with which the Code is concerned. Ordinary criminal recklessness will most often involve conduct and results which are prima facie undesirable and which can be characterized as reckless without any reference to law. The physical actions with which the Code is concerned will almost invariably be done intentionally (in both the colloquial and the Code sense) but not recklessly as that term is commonly understood. The result of such actions will usually be indeterminate, *i.e.*, the fact and magnitude of gain or loss to the investor may not be known for some time, and frequently would be determined in large measure by factors independent of the conduct.[229] In consequence, it may be appropriate to give the Code a higher culpability predicate than the general criminal law. If so, retention of the term recklessly in both contexts is unwise.

The fact that virtually all conduct within the purview of the securities laws is intentional narrows the potential scope of the recklessly standard. Recklessness would seem to be confined to the circumstances surrounding the conduct (*i.e.*, the business facts which cause the prima facie innocent conduct to be colored with illegality), violation by inaction rather than action, and violation in ignorance of the law. The last, however, is ruled out entirely by the explicit provision that knowledge of the provision violated is not necessary for intentional, let alone reckless, violation. Violation by inaction would be relevant only if it were impossible to characterize inaction as intentional. That would not seem to be true as a general proposition, but even if it is, the recklessly standard

228 FSC § 1517(b)(1)(B).

229 We have already seen that the law is not concerned about gain or loss in individual transactions. See text accompanying notes 48-51 *supra*. But that is simply another way of saying that the action cannot be labeled prima facie undesirable except by reference to the law.

would be of little help. First, many failures to act can be reached because they only become a problem when the defendant later does act; *e.g.*, failure to file offering statement followed by issuance of securities. Second, most failures to act would be intentional if the defendant failed to act despite his awareness of the law. But third, if the defendant were ignorant of the law, it would seem that his failure to act could not be reckless for the element of "*conscious*" disregard would be lacking. Whatever room remains for violations by inaction which are unintentional but reckless would be so small as not to justify use of the standard in the Code.

All that remains is recklessness as to the surrounding circumstances, which appears to be the target of the recklessly provision. Yet even here, the potential scope of the recklessly standard is remarkably narrow, because intentional violation requires knowledge of the attendant circumstances,[230] and knowledge is defined to include "awareness by a person of a high probability of the existence of a particular fact, unless he actually believes that it does not exit."[231] Awareness of the high probability would seem closely akin to the conscious disregard required for recklessness. This is not to say that there is no difference, but that there is not very much.

In sum, the recklessly standard is both unnecessary and inappropriate. It could be dropped entirely, and parallel with the proposed Federal Criminal Code maintained by simply retaining the present intentionally standard as the sole predicate to criminal conviction for violations not involving misrepresentations. In any event, it should be dropped as a separate standard because the Code need be concerned only with intentional conduct. If there is great fear that a few malefactors might escape for lack of a recklessness standard with respect to the circumstances surrounding conduct, the definition of intentionally could be modified to read as follows:

> 1517(b)(1) For the purposes of this section, a person violates "intentionally" if, when he engages in conduct of the specified kind, (A) it is his purpose to do so or to cause the specified result, and (B) he either knows that the attendant circum-

230 FSC § 1517(b)(1)(A)(ii).
231 *Id.* § 251A.

> stances that are specified exist or engages in the conduct in conscious and clearly unjustifiable disregard of a substantial likelihood of the existence of the attendant circumstances that are specified.

This definition would enable the Code to salvage what little value there is in the recklessly standard, and perhaps to enjoy the similarly small potential for benefit from the language of the recklessly standard of the Federal Criminal Code.

The second broad area in which the Code's provisions on the culpability required for criminality of non-misrepresentation violations might be improved upon is that of knowledge and advice of counsel. The Code provisions as they now appear do not detract from the superiority of the Code approach to culpability over the pattern of present law, with its sadly inconsistent use of the willfully concept. A definitive position on knowledge is plainly desirable, and the draftsmen are also to be applauded for explicitly addressing the relevance of advice of counsel. The remaining task is to seek a clearer path to a just and unequivocal formulation of the impact of such advice on culpability and the ability of the state to impose criminal sanctions.

A profoundly distressing feature of Code is the implicit failure, widespread throughout our legal system, to recognize the contradiction in purporting to require a bad purpose to justify criminal punishment for acts said to be wrong in themselves but not for acts which are innocent except for the presence of a law.[232] A better view is that "some acts are immoral regardless of the actor's ignorance of their being legally forbidden . . . whereas other acts are immoral only because the actor knows they are legally forbidden."[233]

Most, if not all, non-misrepresentation securities law violations fall in the latter category. They are immoral, *i.e.*, culpable, only if the violator knows he is violating the law. Taking the example most central to the purpose of the federal securities laws, it is difficult to work up much moral indignation against the person who

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232 *See* Morissette v. United States, 342 U.S. 246 (1952). *Compare* United States v. Murdock, 290 U.S. 389 (1933) *with* United States v. Illinois Cent. R.R., 303 U.S. 239 (1938).

233 J. HALL, *supra* note 38, at 403.

sells a security without first obtaining the bureaucrats' permission to do so, especially if the seller did not know he was required to ask permission. The purpose of requiring permission, of course, is to guarantee full disclosure to the buyer. But the buyer is not concerned, for he buys considering whatever knowledge he has sufficient to make that decision. He undoubtedly has alternative investment opportunities which do provide him with the required disclosure, and the purchase of securities is hardly a necessity in any event. It is therefore difficult to imagine a more voluntary choice than that of selecting a security for investment. Furthermore, it is difficult to say that anybody was injured by the transgression, for the success or failure of the enterprise is not determined by the information furnished investors. Finally one should observe that the greater the buyer's greed, the more likely he is to buy upon promises of success rather than sober reflection on the prospects of the enterprise, engendering a feeling that the buyer has received his just desserts if his investment does turn out to be worthless.

One should therefore experience a little reluctance at putting the ignorant securities law defendant on the same plane as the reckless driver who, whether aware of the law or not, knowingly increases the likelihood of severe injury to others. There is of course the counter-argument that the securities defendant should have known — when that claim can be made reasonably. But there is simply no avoiding the conclusion that for non-misrepresentation violations of the securities laws a finding of knowledge is essential to significant culpability.

The problem of ignorance for non-misrepresentation securities law violations is largely hypothetical, for most people involved in actions covered by the non-misrepresentation provisions are reasonably sophisticated regarding the presence of the securities laws. They know what the law is. The issue is how it applies to their activities. To find out they consult a lawyer. So the greatest practical problem regarding culpability and criminal sanctions for non-misrepresentation securities law violations is the effect of good faith reliance on advice of counsel on the characterization of violations.[234]

234 "In light of the consistent reliance upon advice of counsel by the business

The starting point for a venture into this troubled area must be recognition that mere reliance on advice of counsel cannot be conclusive against criminal conviction. If advice of counsel were a conclusive defense the law would be rendered impotent by the unquestioned ability of evil-doers in the securities field, where the promise of monetary gain from wrongdoing is high, to find attorneys to furnish the advisory shield. The minimum requirement must be good faith reliance on counsel's advice.

The Code provisions on knowledge of the law[235] and advice of counsel[236] interact in such a way that a defendant's ignorance of the law becomes worse than "no excuse"; it is affirmatively penalized. The knowledge provision — that a person "need not" have knowledge to violate intentionally or recklessly — does not at first glance seem necessarily to render the defendant's knowledge absolutely irrelevant. But if knowledge is not required for intentional violation, it must be irrelevant, for the "conduct" and "result" as to which purposefulness is required must necessarily be devoid of a knowledge requirement. Since the law is boiled out of the definition of "intentionally" there is no need to worry about whether a person's purpose was to violate the law despite his uncertainty as to what it provided. While knowledge would seem at first glance to fit more readily into the "recklessness" standard, it can have no place thereafter its exclusion from the "intentionally" domain, for the latter implies greater culpability than recklessly. Making advice of counsel relevant must be to make counsel's advice a mitigating factor. Thus, when advice of counsel is obtained, it would appear that some element of bad purpose must be present to overcome the mitigating influence of reliance on advice. Therefore, the person who is trying to stay just this side of the line of illegality would be better off than the innocent who blundered into a violation, a rather unappealing result.

These problems with the Code are, however, merely elaborations on a more basic difficulty. The Code fails to provide that a defendant's good faith belief that his conduct was lawful will bar

community, it would appear necessary for the courts to clearly resolve the question whether bona fide reliance on the erroneous advice of supposedly competent counsel is a defense to a section 5 criminal charge." Mathews, *supra* note 178, at 953.

235 FSC § 1517(b)(2).

236 *Id.* § 1517(b)(3).

criminal conviction for non-misrepresentation violations. The Code should so provide, at least in this writer's view, because low-culpability criminal liability is both repugnant to our best instincts and quite unnecessary to the protection of the capital market.[237]

Of course low-culpability criminal liability is common in fields which, like securities regulation, involve public welfare offenses. The securities laws are intended to prevent not only harm to individuals in discrete transactions, but also the much more abstract and diffuse harm to the system believed to result from a pattern of non-disclosure, a harm which results regardless of the individual violator's mental state and despite the fact that individual violations are often innocuous. There is no way to change the pattern without attacking the individual violations.

Nevertheless, the criminal provisions of the securities laws fail to meet the Supreme Court's criteria for public welfare offenses.[238] The penalty for conviction of a non-misrepresentation violation of the securities laws, both today and as proposed in the Code, is relatively large, and a felony conviction presumably would do grave damage to the offender's reputation, just the opposite of what Justice Jackson suggested characterizes the public welfare offense. The accused in a securities law case may well not be "in a position to prevent [the violation] with no more care than society might reasonably expect and no more exertion than it might reasonably exact from one who assumed his responsibilities."[239] That certainly does not sound like the description of a person who has consulted, paid for, and relied in good faith upon the advice of counsel.

Low-culpability non-misrepresentation securities law violations also fail the necessity test.[240] Certainly any claim that they represent, either individually or collectively, what Justice Jackson termed a threat "to the social order as presently constituted"[241] would be rather far-fetched. Neither do such violations significantly impair the efficiency of the securities laws. Given the enormous role of professionals in the securities business, ignorance

237 *But see* J. HALL, *supra* note 38, at 382-87.
238 Morissette v. United States, 342 U.S. 246, 250-56 (1952).
239 *Id.* at 256.
240 See text accompanying note 36 *supra*.
241 342 U.S. at 256.

will be rare. The continual need to rely upon expensive legal counsel to guide one through the maze of securities laws is itself a much greater inefficiency than the occasional instance in which good faith reliance on such advice nevertheless leads to a violation. The paucity of prosecutions for non-misrepresentation violations[242] indicates that that species of violation, and a fortiori the subspecies of low-culpability violation, have not been much of a problem. Perhaps explicitly removing the deterrent effect of the possibility of criminal violation despite reliance on advice of counsel would produce a nudge in the wrong direction, but such a nudge would surely be slight in view of the other factors weighing in against chancing violation.

The provisions for civil liability are a powerful impetus to compliance with the law. This is particularly so with respect to the central focus of the federal scheme — disclosure-oriented registration.[243] Administrative sanctions are a bludgeon in the hands of the Commission which is and should be available for low-culpability violations. Securities industry professionals are involved in most transactions with which the federal securities laws are concerned. Virtually all of them will be aware of the law, and they will inform those with whom they deal out of self protection, if for no other reason. Thus, the Commission's administrative powers are a powerful direct alternative to criminal sanctions and a powerful indirect force for knowledge of the law, further reducing the incidence of genuine ingnorance. The injunction is also an effective enforcement tool. It can be followed, if necessary, by prosecution for criminal contempt.[244] The Commission can require a halt to distributions and block or undo mergers.

Given this case against criminal sanctions for low-culpability non-misrepresentation violations of the securities laws, it is necessary to seek alternatives to the Code's present formula for criminal liability. One choice might be to require proof that the defendant

242 The vast majority of criminal prosecutions have been for fraud; prosecutions for violation of the registration provision of the Securities Act (§ 5, 15 U.S.C. § 77e (1970)) have been rare except in conjunction with fraud prosecutions. *See* 3 Loss, *supra* note 2, at 1993-94; 6 *id.* at 4136. And if the best justification for a criminal penalty is that it serves as a back-up to catch defendants who escape fraud conviction, then the case for retention of that penalty is very fragile indeed.

243 *See* Sec. Act §§ 11, 12, 15 U.S.C. §§ 77(k), (*l*) (1970).

244 *See, e.g.*, United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969).

believed, in the sense that he thought it more likely than not, that his conduct was unlawful. If the earlier recommendation to drop the recklessly standard[245] were adopted, the new standard could be included in the definition of intentionally. Or it could be set out separately as the knowledge and advice of counsel provisions now are. A second method of ensuring that criminals are culpable would be to require proof that the defendant lacked good faith belief that his conduct was lawful. This standard presumably would ensnare the hypothetical person who neither knew nor cared one way or the other. But it has the disadvantage of being a negative, which would seem to make it a bit more cumbersome to deal with. Given the desirability of only convicting those deserving such a fate and the comparative ease of working with a concept requiring affirmative proof, the former standard seems preferable. Implicit in both of these standards, however, is the notion that good faith reliance on advice of counsel is a bar to criminal conviction.

Neither standard would in practice work as severe a change from the Code as one might expect. Neither requires actual knowledge that the particular provision violated was being violated, or even that it exists, so they are not as hard on the prosecution as they might be. The good faith and belief standards, however, do embody a considerable degree of culpability while at the same time reducing the possibility of avoiding conviction by agreeing not to know, playing dumb, or however attempts to "know without knowing" may be described. Genuine ignorance of the law would bar conviction, but it would be rare. The Commission's other weapons guarantee that the potential escape from criminality will not unduly encourage ignorance, which would seem to be the primary danger lurking behind the proposition that ignorance of the law is no excuse.

One problem with making good faith reliance on advice of counsel a bar to criminal conviction is that it frustrates our desire to discriminate between differing lawful motives — sparing the person whose sole desire is to comply in all respects and catching the one attempting to walk along the edge of illegality. Unfortunately it cannot, apparently, be done. The frequent response is

245 See text accompanying and following notes 228-31 *supra*.

that therefore no violators should escape. But that reaction is unnecessary in the securities law context. The reasons for avoiding the securities laws if possible may range from a simple desire to save time and money, to avoiding Commission scrutiny, to defrauding investors. There is nothing illicit about the first two and the fraud provisions are available to combat the third. Those who desire only to comply with the law and those who have legitimate reasons for not doing any more than they have to should not be branded criminals; those with illicit motivations may be pursued via the fraud provisions (or administratively, or through civil damage suits). A second problem is the threat to the important goal of relative certainty in the meaning of a law provided by the possibility of thousands of attorneys each being official interpreters thereof. But that problem is obviated by the Commission's administrative powers and the courts' roles in reviewing administrative determinations and handling civil damage actions.

If requiring proof of defendant's belief that his conduct was unlawful seems too radical a proposal, other, less far-reaching alternatives should be considered. Good faith belief in the legality of conduct could be made an affirmative defense. Stopping short of tolerating ignorance would be to make good faith reliance on advice of counsel that the course of conduct was legal a defense. In conjunction with the latter or standing alone, it would seem appropriate to broaden the prison avoidance provision to include all non-mispresentation violations for which the defendant could convince the court that he was unaware of the provision violated. But these are essentially half-way measures, which recognize but fail to handle adequately the problem of low-culpability criminal liability.

B. *Violations Involving Misrepresentations*

1. Present Law: Willfully in Practice

Despite the use of the willfully concept as the predicate to both administrative and criminal sanctions for violations involving misrepresentations, the duty of care approach which has been so prominent on the administrative side has hardly appeared on the criminal, where the emphasis has been more on knowing mis-

representation or intent to defraud. The degree of culpability required to impose criminal sanctions is a function of two variables, the willfully concept and the mental element included in the substantive fraud provisions. The precise effects of this interaction are unclear.

Patently deliberate misrepresentations initiated by the defendant pose no problem.[246] But when the defendant's guilty knowledge is ambiguous, the cases do not yield a clear rule. In *United States v. Simon*[247] the court, affirming convictions based on the general false statements[248] and mail fraud[249] statutes and the false reports provision of the Securities Exchange Act[250] stated:

> Nothing turns on the different phrasings of the test of criminality on the three statutes. The Government concedes it had the burden of offering proof . . . not merely that the financial statement was false or misleading in a material respect but that defendants knew it to be and deliberately sought to mislead.[251]
>
> Its burden was not to show that defendants were wicked men with designs on anyone's purse, which they obviously were not, but rather that they had certified a statement knowing it to be false.[252]

The value of *Simon* as an accurate statement of the requirements of the mail fraud statute may be limited, since the case can be interpreted as holding the government to an indictment that went beyond the statutory minimum and alleged knowing falsity. Furthermore, knowing falsehood would seem not to be required by the general penal provision of the Securities Exchange Act, for it uses willfully for most offenses but willfully *and* knowingly with respect to false reports. However, the Securities Act uses willfully without any mention of knowingly. And it may be that knowledge is required in any case by the substantive fraud provisions. The language of *Simon* suggests that since the fraud provisions of the

246 *See, e.g.*, United States v. Peltz, 433 F.2d 48, 53 (2d Cir. 1970); United States v. Schaefer, 299 F.2d 625, 629 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962).

247 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

248 18 U.S.C. § 1001 (1970).

249 *Id.* § 1341.

250 § 32, 15 U.S.C. § 78ff (1970). Both this and the general false statements provision (18 U.S.C. § 1001 (1970)) require knowing and willful misrepresentation.

251 425 F.2d at 798.

252 *Id.* at 809.

securities acts require the same standard as the mail fraud statute, the knowing falsity explicitly required for misrepresentations in filings under the Securities Exchange Act is required for violations of the general fraud provisions in the securities statutes, despite the use of the willfully concept unadorned by "knowingly" in the general fraud provisions.

However, actual knowledge of the falsehood is not essential under either the fraud[253] or false report[254] provisions. One court considering, in the administrative context, the question of whether knowledge is required for willfulness when the defendant passes on a misrepresentation, thought that the "attendant conditions" there "were more than sufficient to put the petitioners on notice that something was wrong. Under such circumstances they were under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the criminal provisions of the Securities Act . . . ."[255] On the other hand, there is some support for the proposition that specific intent to defraud is required.[256] Thus while actual knowledge of falsity may not be required for conviction, the approach is much more knowledge-oriented than on the administrative side.

2. The Code Compared with Present Law

The Code requires scienter as a predicate to criminal sanctions for misrepresentations,[257] just as it does for administrative sanctions.[258] The major changes from present law are the careful definition of misrepresentation (and related terms) and the replace-

253 *See* United States v. Henderson, 446 F.2d 960, 966 (8th Cir.), *cert. denied*, 404 U.S. 991 (1971) (reckless disregard suffices); United States v. Benjamin, 328 F.2d 854, 862 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964) (applying willfully in Securities Act § 24, 15 U.S.C. § 77x (1970), to § 17(a), it would suffice that "defendant deliberately closed his eyes to facts he had a duty to see, [citations omitted] or recklessly stated as facts things of which he was ignorant.").

254 *See* United States v. Wolfson (Merritt-Chapman & Scott), 437 F.2d 862 (2d Cir. 1970). Although reversing defendant's conviction under the false filing provision of Securities Exchange Act § 32, 15 U.S.C. § 78ff (1970), on other grounds, the court indicated that defendant corporation president "must assume responsibility for the contents of [the corporation's 10-K] reports, if he had or should have had knowledge of any material omissions therefrom." 437 F.2d at 872. Just how such a standard could be consistent with the presence of "knowingly" along with "willfully" in § 32 is less than clear.

255 Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967).

256 *See* Mathews, *supra* note 178, at 929, 954.

257 FSC § 1517(a)(1).

258 *Id.* §§ 1507(a)(4)(A), 1571(a).

ment of willfully by scienter. These terms were analyzed in some detail in the discussion above of administrative sanctions for misrepresentations.[259] The knowledge-oriented scienter concept would appear to impose a standard something akin to that indicated by the court in *United States v. Simon*[260] as applicable under the willfully and knowingly standard of the false report provision. There the government's "burden was . . . to show that defendants . . . had certified *a statement knowing it to be false.*"[261] Substitution of "a false statement with scienter" for the italicized words would yield the Code standard.

To the extent that knowledge of falsity is not now required, the scienter standard might tighten existing law. However, since the scienter concept might even be sufficiently flexible to accommodate the duty of care approach of present law regarding administrative sanctions for misrepresentations, it seems evident that any change might in fact go the other way. Whatever change might occur would, however, probably be imperceptible.[262]

The scienter standard clearly would not require specific intent to defraud, so to the extent, if any, that such is presently required[263] a change would be effected. The change probably would have little practical effect, for many misrepresentations are made with designs on people's purses, and most of those which are not probably would fall under the false reports provisions of present law, where specific intent to defraud is not required. At most, the change would ease the prosecution's burden slightly by eliminating an element of the offense. The impact on the likelihood of conviction is dubious, however, given the unquestionable correlation between liars and cheats.

3. The Code Evaluated

The scienter standard is an innovation which should greatly improve the present state of conceptual affairs on the criminal side of misrepresentations, without resulting in radical change from what appears to be the satisfactory state of the present system in

259 See text accompanying notes 149-57 *supra.*

260 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970).

261 *Id.* at 809 (emphasis added).

262 An exception is the considerable danger of a dilution of the criminal standard posed by the recommendation that scienter also be used on the administrative side.

263 See note 256 *supra.*

practice. The willfully concept is wisely abandoned and the desirability of avoiding the present pattern, which exhibits at least the appearance of piling culpability on top of culpability with the willfully standard and fraud language, is beyond question.

With scienter there would no longer be any question of one standard of culpability superimposed over another. Scienter has a bad purpose flavor that coincides directly with the evil at which the misrepresentation provisions are aimed — the influence of investment decisions by false information or appearances. The knowledge orientation of the scienter concept will result in at most an insignificant change. Clear elimination of specific intent to defraud as an element of criminal misrepresentations is desirable because the misrepresentation itself is a serious blow to the integrity of the system. The scienter element requires sufficient culpability to justify the imposition of sanctions against persons perpetrating such harm. Requiring proof of an intention to cheat would be superfluous.

The Code scheme on misrepresentations makes no reference to the relevance that knowledge of the provision violated and advice of counsel have on criminal liability. The absence is conspicuous since those matters are explicitly dealt with for violations not involving misrepresentations.[264] Nothing need be said about knowledge because it is virtually inconceivable that any court would find knowledge of the provision violated a predicate to conviction of an offense involving a misrepresentation. The moral element is too strong and too well known to make any other result sensible.

Omission of a provision on advice of counsel is a bit less obvious, especially since most of the noise regarding advice of counsel is made in the cases dealing with misrepresentations.[265] The omission again turns out to be understandable. The fraud cases are replete with the assertion that the accused is entitled to an instruction that good faith is a defense and that reliance on the advice of counsel, if not a separate defense, is at least an element of the good faith defense.[266] Under the Code, good faith would eliminate mis-

264 FSC §§ 1517(b)(2) & (3).

265 *See, e.g.*, Kroll v. United States, 433 F.2d 1282, 1285-86 (5th Cir. 1970); Tarvestad v. United States, 418 F.2d 1043, 1047 (8th Cir. 1969), *cert. denied*, 397 U.S. 935 (1970); United States v. Painter, 314 F.2d 939, 943 (4th Cir. 1963); *cf.* Bisno v. United States, 299 F.2d 711, 719-20 (9th Cir. 1961), *cert. denied*, 370 U.S. 952 (1962); Linden v. United States, 254 F.2d 560, 568 (4th Cir. 1958).

266 *See* cases cited at note 265 *supra*.

statements and omissions from characterization as misrepresentations, and hence prevent conviction — provided that the other two conditions for escape from the prima facie definition of misrepresentation were complied with.[267] But they may not be; in that event it becomes significant that both advice of counsel and good faith are apparently included in the scienter concept. Reliance on advice of counsel or anyone else will be admissible on the issue of scienter if it is relevant to the defendant's state of mind regarding the falsity of the misrepresentation. Beyond that, reliance on the advice of counsel is irrelevant.

Conclusion

The willfully concept is sprinkled liberally over the federal securities laws as a predicate to administrative and criminal sanctions for violation of those laws. Although the concept is so spineless as to make any predictions of its behavior extremely hazardous, recollection that the laws were drafted in an earlier age of administrative law, at a time when the Supreme Court was still seen as a threat to congressional attempts at economic regulation, suggests that the draftsmen may have intended to take the willfully concept seriously, clothing it with high culpability and bad purpose.

Forty years' experience has established that willfully in the administrative context means no more than that the respondent was conscious of his actions. Culpability simply is not required, but that is as it should be given the evolution of the Securities Exchange Commission's preventive role. The meaning of willfully in the criminal context remains unsettled between positions of low and high culpability. That is a matter of great concern, for low-culpability criminal liability is grossly inappropriate in the securities law context because of heavy penalties, difficulty of compliance and the availability of numerous alternatives for protecting the capital market.

The draftsmen of the Federal Securities Code would abandon the willfully concept altogether and differentiate between violations involving and not involving misrepresentations, as well as between the administrative and criminal contexts, in the predicates to sanctions for federal securities law violations. The

267 See text accompanying note 150 *supra*.

Code as presently drafted is conceptually superior to present law, for the Code provisions permit reaching roughly the same practical results with much less strain in interpretation. This is particularly true of the "without reasonable justification or excuse" and "scienter" predicates to the imposition of administrative sanctions for non-misrepresentation violations and to criminal sanctions for misrepresentation violations, respectively. The other Code predicates, however, are susceptible of improvement in the interests to clarity and of a rational and just approach to criminal responsibility.

The scienter predicate to administrative sanctions for violations involving misrepresentations should be dropped in favor of the "without reasonable justification or excuse" predicate now used for non-misrepresentation violations. The latter standard, unlike scienter, is well adapted to the explicit duty of care approach which has found favor in this context. The without reasonable justification or excuse standard would be effective because there is no excuse for misrepresentations made with scienter. More ominously, use of scienter as the predicate to both administrative and criminal sanctions, as is presently provided in the Code, opens the possibility of a repeat performance, though admittedly on a smaller scale, of the willfully debacle.

The Code provides that criminal conviction for violations not involving misrepresentations may be obtained upon proof that the defendant violated "intentionally" or "recklessly," each of which is elaborately defined and further subject to the provisos that knowledge of the provision violated is not necessary and reliance on advice of counsel is relevant but not conclusive in determining whether a violation was intentional or reckless. The recklessly standard is of little use and may either be discarded entirely or trimmed substantially and made part of the intentionally standard. The Code provisions on knowledge, as applied to both conviction and prison avoidance, and on advice of counsel should be dropped in favor of a provision making good faith belief in the legality of the conduct a shield from criminal liability. Failing the adoption of such a provision, the Code should be modified to make a somewhat greater dent in the problem of low-culpability criminal liability.

ANTITRUST COURTS VERSUS THE SEC: A FUNCTIONAL ALLOCATION OF DECISIONMAKING ROLES

MARK ELLIOTT MAZO*

Introduction

The policy inherent in American antitrust law of maintaining competition unfettered by collusive restraints necessarily conflicts with securities law policy of self-regulation by the securities industry. These conflicting policies generate a second conflict — a conflict of decisionmaking authority. The federal courts provide the principal forums for the resolution of antitrust disputes, while securities regulation is primarily supervised by the Securities and Exchange Commission (SEC). In consequence controversies over which of these bodies will resolve antitrust-securities policy conflicts have inevitably arisen.

This article is intended to analyze and propose a resolution of these decisionmaking conflicts. First, the conflicting policies of antitrust and securities law will be described. Second, the capability and effectiveness of each forum in resolving antitrust-securities policy conflicts will be considered. Third, conclusions and proposals for legislative action to resolve the decisionmaking conflict will be presented.

I. ANTITRUST AND SECURITIES INDUSTRY REGULATION

A. *Antitrust Regulation: Policies and Forums*

Antitrust policy may affect the securities industry at two levels. First, a particular collusive securities *practice* may be challenged under antitrust policies. Of the many prohibited forms of anti-

*Member of the District of Columbia Bar. A.B., 1971, Princeton University (Woodrow Wilson School); J.D., 1974, Harvard University.

competitive behavior, the antitrust laws[1] have classically prevented competing firms from joining together for monopolistic advantages.[2] These collusive practices are generally objectionable because of the serious anticompetitive effects and the illusiveness of redeeming advantages.[3] Only where anticompetitive effects are outweighed by beneficial results may the collusive restraint be allowed.[4]

Second, the securities *industry* may seek exemption from antitrust laws. The fundamental role of competition in American economic life, however, has generated a strong presumption in favor of broad application of antitrust policy. As Professor Baxter has written:

> The presumption in favor of free markets pervades our legal and industrial institutions. Congress may, of course, reject that choice with regard to a particular industry, but the rejection and the resultant conferral of a special status should be expressed with unmistakeable clarity so that each Congressman and each constituent may know exactly what is at issue.[5]

The extent to which Congress, in creating a scheme of securities regulation which requires collusive self-regulation,[6] meant to exempt the industry from antitrust laws thus becomes a central question in the antitrust-securities policy conflict.

The forums predominantly concerned with applying antitrust laws to the securities industry are the federal courts. They have been active in the resolution of antitrust-securities conflicts.[7] Although the Federal Trade Commission (FTC) can issue cease and

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1 Sherman Act, ch. 647, 26 Stat. 209 (1890), *as amended*, 15 U.S.C. §§ 1-7 (1970); Clayton Act, ch. 323, 38 Stat. 730 (1914), *as amended*, 15 U.S.C. §§ 12-19, 20, 21, 22-27 (1970).

2 P. AREEDA, ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES ¶ 300 (2d ed. 1974).

3 *Id.* ¶¶ 306-13, 328, 391(d).

4 *E.g.*, Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925); Chicago Board of Trade v. United States, 246 U.S. 231 (1918); United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953).

5 Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675 (1970).

6 The Supreme Court has noted that the Exchange Act envisions "the effective operation of a public policy contemplating that securities exchanges will engage in self-regulation which may well have anti-competitive effects in general and in specific application." Silver v. NYSE, 373 U.S. 341, 349 (1963).

7 *See* cases cited in notes 29, 50 & 66 *infra*.

desist orders against "unfair methods of competition,"[8] it has not concerned itself with antitrust-securities conflicts. Congressional delegation of securities regulation to the exchanges, dealer associations, and the SEC makes FTC intervention into anticompetitive aspects of the industry highly questionable.[9] The Antitrust Division of the Justice Department has tried vigorously to extend antitrust principles to the securities industry through the judicial and legislative process. The Division has submitted briefs in private suits[10] and participated in congressional hearings concerning the securities industry.[11]

B. *Securities Industry Regulation: Policies and Forums*

1. The Exchanges

In 1934 Congress enacted the Securities Exchange Act,[12] instituting a scheme of regulation with four primary purposes:

> . . . to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation's credit which goes into those markets.[13]

The economic goals of the Act have been more specifically delineated as (1) establishing a broader and more liquid auction market, (2) permitting members of securities exchanges to give maximum public service, and (3) allowing the industry to function at the lowest cost consistent with high quality and sound business prac-

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8 Federal Trade Commission Act § 5(b), 15 U.S.C. § 45 (1970).

9 *Cf.* 3 TRADE REG. REP. ¶¶ 9850.01-9852 (liaison agreements between FTC and the Food and Drug Administration and the Federal Communications Commission acknowledge FTC jurisdiction only over unfair advertising in the respective industries). *But cf.* Chamber of Commerce v. FTC, 13 F.2d 673 (1926) (FTC had jurisdiction over some matters of grain exchange operation despite Grain Futures Act of 1922).

10 *E.g.*, Brief for Justice Department as Amicus Curiae, PBW Stock Exchange v. SEC, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3610 (U.S. Apr. 11, 1974) [hereinafter cited as Just. Dept. PBW Brief].

11 *See Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. 193 *et seq.* (1973) [hereinafter cited as *S. 2519 Hearings*].

12 48 Stat. 881 (1934), *as amended*, 15 U.S.C. §§ 78a-111 (1970).

13 1 L. LOSS, SECURITIES REGULATION 130-31 (2d ed. 1961).

tices.[14] Achieving these purposes would protect investors and promote an efficient market for securities, thereby assuring investor confidence in the securities markets and facilitating the subscription of capital from the public.

The Act has established a two-tier system of regulation. At the first level the industry itself, acting through existing stock exchange structures, enacts and enforces rules of conduct. Each exchange must adopt rules of conduct for its members which are consistent with just and equitable principles of trade.[15] Although the record of securities industry self-regulation has been subject to criticism,[16] Congress is likely to retain this form of regulation.[17]

The second component of the regulatory scheme is the Securities and Exchange Commission. The Commission's direct, statutory authority over existing exchanges is limited to a few areas. Under § 6 the Commission must approve exchange rules before an exchange can be registered.[18] Under §§ 10 and 11 the SEC

14 SEC, REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. No. 88-95, 88th Cong., 1st Sess. pt. 2, at 331 (1963) [hereinafter cited as SEC SECURITIES STUDY].

15 No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

. . . .

If it appears to the Commission that the exchange . . . is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

Securities Exchange Act of 1934 §§ 6(b), (d), 15 U.S.C. §§ 78f(b), (d) (1970).

16 *E.g.*, Comment, *An Approach for Reconciling Antitrust Law and the Securities Law: The Antitrust Immunity of the Securities Industry Reconsidered*, 65 NW. U.L. REV. 260, 279 (1970): "Yet the securities industry has a record marked with scandal and resistance to innovation and progress. In short, its self-regulatory performance has never been commensurate with its responsibility as an industry at the very heart of our economy."

17 *See* S. 2519, 93d Cong., 1st Sess.; introduced by Sen. Williams of New Jersey, Chairman of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs; reported (S. REP. No. 93-865, 93d Cong., 2d Sess. (1974)) with amendment (S. 3126, 93d Cong., 2d Sess. (1974)) from Senate Comm. on Banking, Housing and Urban Affairs, 120 CONG. REC. S8807 (daily ed. May 22, 1974); passed Senate as reported, 120 CONG. REC. S8958 (daily ed. May 28, 1974); referred to House Comm. on Interstate and Foreign Commerce, 120 CONG. REC. H4629 (daily ed. May 30, 1974) [hereinafter cited as Williams Bill].

18 Securities Exchange Act of 1934 § 6(d), 15 U.S.C. § 78f(d) (1970).

can issue rules governing specialists, odd-lot dealers, floor traders, short sales, and manipulative and deceptive devices.[19] Section 19(a) empowers the SEC to suspend or withdraw registration of a national securities exchange if it has either violated the Act or has failed to enforce its rules.[20] Under § 19(b) the Commission may request and require exchanges to make specific changes in their rules in certain areas.[21] Except for the drastic sanction of revoking or suspending an exchange's registration, however, the SEC has no power over the specific application of exchange rules.[22]

It is unclear whether the statute authorizes SEC review of anticompetitive behavior in the industry.[23] Investor protection, fair dealing, and fair administration are criteria broad enough to include the anticompetitive effects of exchange rules.[24] But the Act neither requires the SEC to consider anticompetitive effects nor assigns those factors any specific weight in the Commission's judgment.[25] And the Act specifically preserves all other rights and

19 *Id.* §§ 10, 11, 15 U.S.C. §§ 78(j), 78(k).

20 *Id.* § 19(a), 15 U.S.C. § 78s(a).

21 The Commission may alter exchange rules "in respect of such matters as" (1) financial responsibility of members; (2) limiting or prohibiting trading in a security; (3) listing or delisting of a security; (4) hours of trading; (5) manner of business solicitation; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries, and of closing accounts; (8) reporting of transactions and ticker operation; (9) "the fixing of reasonable rates of commission, interest, listing, and other charges"; (10) minimum units of trading; (11) odd-lot transactions; (12) minimum margin deposits; and (13) "similar matters." *Id.* § 19(b), 15 U.S.C. § 78s(b).

Commission power under § 19(b) is limited to changes in existing rules. The SEC lacks authority to prevent an exchange rule from becoming effective. However, using its reporting power, the SEC has issued Rule 17a-8, 17 C.F.R. § 240.17a-8 (1973), requiring exchanges to file with the SEC all proposed rule changes at least three weeks before becoming effective.

22 Silver v. NYSE, 373 U.S. 341, 358 (1963). *Contra,* P. AREEDA, *supra* note 2, ¶ 179(g).

23 The SEC can alter exchange rules if it determines that the changes are "necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange . . . ." Securities Exchange Act of 1934 § 19(b), 15 U.S.C. § 78s(b) (1970).

24 *See In re* Rules of the NYSE, 10 S.E.C. 270 (1941). The primary ground for Commission action in this § 19(b) proceeding was the anticompetitive effect of an NYSE rule preventing NYSE members from becoming specialists or odd-lot dealers in NYSE listed securities on other stock exchanges. *Id.* at 287-88. The courts now seem to acknowledge SEC authority to consider anticompetitive factors. *See* Thill Securities Corp. v. NYSE, 433 F.2d 264, 271-72 (7th Cir. 1970), *cert. denied,* 401 U.S. 994 (1971).

25 Former SEC Chairman William J. Casey testified that while the Commission will consider anticompetitive effects in dealing with the exchanges' fixed commission

remedies under existing law.[26] This reservation of rights enhances the argument that antitrust considerations are not part of SEC considerations. Unfortunately the Act's legislative history does not clarify the issue.[27]

Judicial review of a Commission final order made pursuant to the Act is available to any party who has been adversely affected.[28] A court of appeals may set aside, affirm or modify the order. A finding of fact by the Commission is conclusive if supported by substantial evidence.[29]

2. The National Association of Securities Dealers

In 1938 Congress passed the Maloney Act[30] which extended SEC supervision to the over the counter (OTC) market.[31] Private, voluntary associations of securities dealers are authorized by the Act if they register with the Commission.[32] Only one such association exists — the National Association of Securities Dealers (NASD).[33]

The Commission's direct authority over dealer associations is made more extensive than its authority over exchanges because the OTC market is far less structured.[34] Dealers associations are required to have objective criteria of membership[35] and the organizations may not fix commission rates.[36] The SEC is given direct

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structure, those factors are one of many "to be weighed and balanced and then a broad judgment made as to whether, at what point, or how far a fixed commission schedule is in the public interest." *Hearings on Securities Industry Study Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess., ser. 103, pt. 1, at 108 (1971) [hereinafter cited as *Senate Study Hearings*].

26 Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb (1970).

27 *See* Note, *Antitrust and the Stock Exchange: Minimum Commission or Free Competition?* 18 STAN. L. REV. 213, 224 (1965).

28 *See* 2 L. Loss, *supra* note 13, at 1317-18 n.105.

29 Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a) (1970).

30 Act of June 25, 1938, ch. 677, 52 Stat. 1070, *as amended*, 15 U.S.C. § 78o-3 (1970).

31 The securities industry consists of four distinguishable markets. Those are (1) the organized exchanges; (2) the over-the-counter market for non-listed securities; (3) non-member firms dealing in listed securities (the "third market"); (4) large investors trading directly with each other (the "fourth market").

32 Maloney Act § 15A(a), 15 U.S.C. § 78o-3(a) (1970).

33 2 L. Loss, *supra* note 13, at 1365.

34 Comment, *Antitrust Immunity of the National Association of Securities Dealers Under the Maloney Act*, 14 B.C. IND. & COM. L. REV. 111, 128 (1972).

35 Maloney Act § 15A(b)(3), 15 U.S.C. § 78o-3(b)(3) (1970).

36 *Id.* § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8).

authority to review disciplinary proceedings,[37] to abrogate or alter existing rules,[38] and to prevent new rules from becoming effective.[39] To make membership in a dealer's association attractive, Congress enacted an express policy of competitive restraints.[40] The statute specifically authorizes dealer associations to forbid member broker-dealers from dealing with non-member professionals at a discount from the public rates[41] while it authorizes dealer associations to allow members to trade at a discount with each other.[42] In addition, § 15A(n) expressly repeals inconsistent laws.[43]

3. Public Utility Holding Companies

The Public Utility Holding Company Act[44] expressly authorizes the SEC to approve acquisitions and mergers of companies within the Act.[45] The Commission is required to consider anticompetitive factors and industry concentration before approving the mergers.[46]

C. *Securities Industry Practices and Antitrust Doctrines*

1. Commission Rate Structure

The industry rate structure is largely determined by the New York Stock Exchange (NYSE). With greater membership, trading volume, and efficiency than any other exchange, the NYSE and its policies overshadow the other securities markets.[47] The NYSE rate structure affects competition through three mechanisms. First, competition between members is restricted to non-price areas.

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37 *Id.* § 15A(g), 15 U.S.C. § 78o-3(g).

38 *Id.* § 15A(k), 15 U.S.C. § 78o-3(k).

39 *Id.* § 15A(j), 15 U.S.C. § 78o-3(j).

40 *See generally* Comment, *Over-the-Counter Trading and the Maloney Act*, 48 YALE L.J. 633, 645-46 (1939). *But see* Comment, *supra* note 34, at 129.

41 Maloney Act § 15A(i)(1), 15 U.S.C. § 78o-3(i)(1).

42 *Id.* § 15A(i)(3), 15 U.S.C. § 78o-3(i)(3).

43 "If any provision of this section [the Maloney Act] is in conflict with any law of the United States in force on the date the section takes effect, the provision of this section shall prevail." *Id.* § 15A(n), 15 U.S.C. § 78o-3(n).

44 49 Stat. 838 (1935), *as amended*, 15 U.S.C. §§ 79 to 79z-6 (1970).

45 15 U.S.C. § 79j (1970). Clayton Act § 7, 15 U.S.C. § 18 (1970), expressly exempts from its operation transactions consummated with SEC approval under the Public Utility Holding Company Act.

46 Municipal Electric Ass'n v. SEC, 413 F.2d 1052, 1057 (D.C. Cir. 1969).

47 *Cf.* Ratner, *Regulation of Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 360 (1970).

Second, limited access to the NYSE affects competition between the various exchanges. Finally, the restrictions on off-floor trading in listed securities by exchange members reduces competition among the four securities markets.[48]

At the center of the storm over antitrust regulation of the industry is the NYSE fixed rate of commission.[49] The subject of attack in the courts,[50] in Congress,[51] in the SEC[52] and in the commentaries,[53] the fixed rate of commission is being phased out and by May 1, 1975 should no longer exist.[54] The anticompetitive effect of the fixed commission rate has been somewhat exaggerated. Frequently the fixed rate is circumvented by a variety of rebate devices,[55] although the NYSE attempts to prohibit their use through an anti-rebate rule.[56] The price-fixing policy has been defended as necessary to (1) protect market liquidity; (2) permit members to maintain necessary capacity;[57] (3) assure financial solvency for small firms throughout the country which are integral

48 *See* note 31 *supra*.

49 For a history of the NYSE rate schedule since the "Buttonwoode Tree Agreement" of 1792, *see* Baxter, *supra* note 5, at 676-79.

50 *E.g.*, Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304); Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971); Kaplan v. Lehman Bros., 371 F.2d 409 (7th Cir. 1967); Frederickson v. Merrill Lynch, BNA SEC. REG. & L. REP. (No. 271, Oct. 2, 1974) D-1 (N.D. Ill. Sept. 9, 1974); Crimmins v. Amex, 368 F. Supp. 270 (S.D.N.Y. 1973).

51 *E.g.*, S. 470, 93d Cong., 1st Sess. (1973).

52 *E.g., Hearings on Stock Exchange Commission Rates Before the Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 92d Cong., 2d Sess. 6 (1972) (testimony of William J. Casey).

53 *See, e.g.*, Baxter, *supra* note 5; Ratner, *supra* note 47; Note, *supra* note 27; Note, *Fixed Brokerage Commissions: An Antitrust Analysis After the Introduction of Competitive Rates on Trades Exceeding $500,000*, 85 HARV. L. REV. 794 (1972).

54 The SEC has recently proposed rules 19b-3 and 10b-22 (to be effective May 1, 1975) which would, respectively, prevent exchanges from allowing the fixing of rates and prohibit brokers, dealers and exchange members from participating in agreements to fix commission rates. *See* BNA SEC. REG. & L. REP. (No. 275, Oct. 30, 1974) A-1. *See generally* Securities Exchange Act Release No. 10,383 (Sept. 11, 1973); Securities Exchange Act Release No. 11,019 (Sept. 19, 1974).

55 *See* 5 L. Loss, *supra* note 13, at 3173-86; Jennings, *The New York Stock Exchange and the Commission Rate Struggle*, 21 BUS. LAW. 159, 160 (1965): "Indeed [the fixed commission rate schedule] is now little more than a maginot line which enterprising price cutters may by-pass if they adhere to the form, rather than the substance of the antirebate provisions." A 1968 NYSE rule prohibiting rebate practices might be an antitrust violation. *See* Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

56 2 CCH NYSE GUIDE ¶ 1104, art. XV, § 1 (Apr. 4, 1974).

57 Note, *Fixed Brokerage Commissions*, *supra* note 53, at 810-12.

links in the nationwide network of raising capital;[58] (4) prevent economic discrimination against small investors; and (5) prevent oligopoly resulting from the extensive price cutting in which large firms can engage because of their internal cost structure.[59] All of these arguments have been disputed, refuted or discounted by the Justice Department and commentators.[60]

Closely related to fixed rates are "bundled" rates. The fee charged each customer includes the entire range of brokerage services (*e.g.*, execution, clearance, registration, delivery, research, and custodial care) even if the customer neither desired nor received them all.[61] This practice forces the small customer to subsidize the services most often utilized by the large buyer.[62] Freely competitive rates would end bundling and encourage the separation of charges for the various services performed by the broker.[63]

The NYSE has long restricted access to the exchange by preventing "institutions"[64] from attaining exchange membership.[65] Enforcement of this practice was attacked in the courts as a group boycott in violation of antitrust laws.[66] The practice was upheld because the SEC was in the process of adopting Rule 19b-2, which requires exclusion of institutions from membership in exchanges.[67]

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58 *Hearings on Securities Industry Study Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 2d Sess., ser. 92-37(e), pt. 6, at 3132 (1972) (speech by Abe Fortas) [hereinafter cited as *House Study Hearings*].

59 *See* Baxter, *supra* note 5, at 694-99.

60 *Id.* at 694-703.

61 *See* Ratner, *supra* note 47, at 350-51.

62 Johnson, *Application of the Antitrust Laws to the Securities Industry*, 20 SW. L.J. 536, 540 (1966).

63 McLaren, *Antitrust and the Securities Industry*, 11 B.C. IND. & COM. L. REV. 187, 189 (1970).

64 The defining characteristic of institutions is the receipt of a substantial amount of income from non-broker-dealer transactions. *See* note 67 *infra*.

65 *See* 2 CCH NYSE GUIDE ¶ 2318, Rule 318, *as amended*.

66 Stark v. NYSE, 346 F. Supp. 217 (S.D.N.Y. 1972), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972). *See* United States v. Terminal R.R. Ass'n, 224 U.S. 383 (1912), and Associated Press v. United States, 326 U.S. 1 (1945), which establish the antitrust principle that a private group controlling access to a market must grant access to that market on an equitable and non-discriminatory basis to all those in the trade.

67 Stark v. NYSE, 346 F. Supp. 217 (S.D.N.Y. 1972), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972). Rule 19b-2 obligates exchanges to adopt rules requiring that "every member have as the principal purpose of its membership the conduct of a public securities business." This is defined as transacting at least 80% of the value of its business with persons other than an "affiliated person." Affiliated persons includes persons directly or indirectly controlled by, controlling, or under common

Access to the exchange has also been restricted by charging prices to broker-dealers that discriminate on the basis of membership.[68] Under SEC pressure the NYSE has modified its old policy of charging non-member broker-dealers the same rates paid by the public. These professionals are now entitled to negotiate a discount up to 40 percent.[69] The SEC has announced plans to assure non-member broker-dealers that their trades will be executed at non-discriminatory rates.[70]

NYSE Rule 394 substantially restricts trading by exchange members off the exchange floor in the third market. Under Rule 394(b) a member may trade off-board only if his third market price cannot be met on the exchange floor. This procedure is cumbersome and has not met the underlying problem that, in some cases, the third market provides a better net price than the exchange.[71]

2. Other Self-Regulatory Practices

Antitrust attacks can also be brought against non-price practices that affect competition within the industry. Rules may be adopted, for example, to protect investors by preventing fraudulent practices or to assure uniformity of procedures for greater industrial efficiency. Yet all self-regulatory rules are collusive restraints of trade which antitrust doctrine makes suspect. NYSE requirements that contracts between members and employees include binding arbitration clauses were attacked unsuccessfully as an unreasonable

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control with such member. 17 C.F.R. § 240.19b-2 (1973). The validity of this rule was under attack primarily for violations of administrative law in PBW Stock Exchange v. SEC, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3610 (U.S. Apr. 11, 1974). The Third Circuit granted the SEC motion to dismiss for lack of jurisdiction without expressing an opinion on the merits under Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a), since the rule was not an appealable order. The court did not examine the antitrust issues. For plaintiffs' antitrust arguments see Just. Dept. PBW Brief, *supra* note 10. The PBW Stock Exchange has renewed the challenge in a new complaint based primarily on antitrust law. *See* PBW Stock Exchange v. SEC, BNA SEC. REG. & L. REP. (No. 263, July 31, 1974) A-6 (E.D. Pa., *answer filed*, July 17, 1974).

68 2 CCH NYSE GUIDE ¶ 1702, art. XV, § 2(h) (1972).

69 *Id.*

70 *SEC Policy Statement on the Structure of a Central Market System*, BNA SEC. REG. & L. REP. (No. 196, Apr. 4, 1973) D-14 [hereinafter cited as *SEC CMS Statement*].

71 *See* Note, *NYSE Rules and the Antitrust Laws — Rule 394 — Necessary Restriction or Illegal Refusal to Deal?*, 45 ST. JOHN'S L. REV. 812, 829-30 (1971).

restraint of trade by a disgruntled employee.[72] The Fifth Circuit has noted that the NASD and its members could be liable under antitrust laws for an "interpretation" of a rule which was encouraged by the SEC to prevent fraud and stock manipulation.[73] Even proposed solutions for solving brokers' paperwork backlog problems of the 1960's were vulnerable to antitrust challenge.[74]

Disciplinary actions by self-regulators, though mandated by the securities laws, commonly take the form of group boycotts and are therefore subject to possible antitrust attack.[75] An antitrust action has been successfully brought against the disciplining of a nonmember by an exchange without affording notice of charges or a hearing.[76] Denial of full exchange membership to a person disciplined for some rule violations may also give rise to a valid antitrust complaint.[77] The antitrust-securities policy conflict can be particularly severe where, for example, an exchange is sued in antitrust for enforcing its rules, and at the same time sued under Securities Exchange Act § 6 for not enforcing its rules vigorously enough.[78]

One further antitrust-securities policy question merits consideration: whether the NASD should be treated differently under the antitrust laws from the exchanges. Greater antitrust liability for the NASD would probably be unwise because it would increase existing competitive advantages of the exchanges relative to OTC market makers, thereby inhibiting competition between these two securities markets. Equivalent or even preferential antitrust treatment for the NASD would further competition. Consistent SEC

72 Dickstein v. duPont, 443 F.2d 783 (1st Cir. 1971) (antitrust claim dismissed because the anticompetitive impact of the arbitration clause appeared too remote).

73 Harwell v. Growth Programs, Inc., 451 F.2d 240 (5th Cir. 1971), *cert. denied*, 409 U.S. 876 (1972).

74 Note, *The Back Office Problem and the Antitrust Laws*, 69 COLUM. L. REV. 299 (1969).

75 *Cf.* Fashion Originators' Guild of America v. FTC, 312 U.S. 457 (1941).

76 Silver v. NYSE, 373 U.S. 341 (1963).

77 Zuckerman v. Yount, 362 F. Supp. 858 (N.D. Ill. 1973) (McLaren, J.).

78 This dilemma occurred when Ira Haupt Co. was suspended from trading after its net capital fell below required levels as a result of liabilities incurred in the "salad oil swindle" of the early 1960's. In Klebanow v. Funston, 35 F.R.D. 518 (S.D.N.Y. 1964) (decision on procedural point), one of Haupt's partners sued the NYSE President for enforcing a group boycott. The NYSE was also sued by another of Haupt's partners for failing adequately to supervise Haupt's affairs. Weinberger v. NYSE, 335 F. Supp. 139 (S.D.N.Y. 1971).

regulatory powers and antitrust treatment for the NASD and the exchanges is being seriously considered by Congress.[79]

II. Pragmatic Allocation of Decisionmaking Functions

A. *Legislative Options of Decisionmaking Schemes*

Three major legislative patterns of allocating authority between regulatory agencies and federal district courts have developed: exemption, concurrent jurisdiction, and exclusive judicial jurisdiction. Under an exemption formula the federal district courts completely lack jurisdiction over antitrust matters within the exempted industry. The regulatory agency has sole authority to determine questions of trade restraints within the industry. The agency applies the standards of the regulatory statute and the courts may not impose antitrust standards. Agency rulings are subject to judicial review under the substantial evidence test.[80]

Exemption emphasizes the relative unimportance of competitive factors in light of other policies.[81] Even where Congress has partially exempted an industry from antitrust laws,[82] however, the regulatory statute may prohibit specific anticompetitive practices,[83] or require the regulating agency to consider the competitive aspects of some decisions.[84] In neither case has Congress eliminated concern for competition. Rather it has recognized that the agency can best balance competitive and non-competitive factors when

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79 *See* Williams Bill, *supra* note 17, §§ 3, 18; *but see* S. Rep. No. 93-865, 93d Cong., 2d Sess., 4, 11 (1974).

80 Administrative Procedure Act § 10(e), 5 U.S.C. § 706(2)(E) (1970).

81 *See* Stokes, *A Few Irreverent Comments About Antitrust, Agency Regulation, and Primary Jurisdiction*, 33 Geo. Wash. L. Rev. 529, 551 (1964).

82 *See* list of statutory exemptions at note 120 *infra*.

83 *E.g.*, CAB approval of air carrier mergers provides antitrust immunity, yet the CAB may not approve mergers which would result in monopoly. Federal Aviation Act of 1958 § 408(b), 49 U.S.C. § 1378(b) (1970). Interlocking directorships are forbidden by Federal Aviation Act § 409(a), 49 U.S.C. § 1379(a) (1970).

84 *E.g.*, for applicability to the ICC, *see* Johns, *The Interstate Commerce Commission and the Department of Justice*, 31 Geo. Wash. L. Rev. 242, 252-54 (1962). For applicability to the CAB, *see* Federal Aviation Act of 1958 §§ 102, 411, 49 U.S.C. §§ 1302, 1381 (1970). For applicability to bank mergers, *see* Bank Merger Act of 1966, 12 U.S.C. § 1828 (1970). *See generally* Hale & Hale, *Competition or Control VI: Application of Antitrust Laws to Regulated Industries*, 111 U. Pa. L. Rev. 46, 50 (1962).

not subjected to the inquiries of an antitrust court that may be concerned almost exclusively with enforcing a competitive model.[85]

Such systems of regulation should be contrasted with any scheme which would exempt an industry from antitrust laws without a requirement (expressed or implied in the standards for the agency's decisionmaking) that the regulating agency consider anticompetitive factors.[86] The latter scheme would be contrary to the pervasive congressional concern that someone — courts, agency, or both — reflect competitive values to some extent in decisions that regulate the industry. That concern is particularly appropriate to the securities industry, where the actual and potential competitive damage of collusive practices exists.[87] It is not surprising therefore that in *Gordon v. NYSE*[88] the court exempted fixed minimum commission rates with a proviso that anticompetitive factors be considered by the SEC, and that the extent of anticompetitive consideration be reviewable judicially.

Under a concurrent scheme of jurisdiction the legislature has by design or inadvertence given jurisdiction to both the courts and the agency. This scheme is appropriate where the legislature is faced with important but unpredictable factors affecting legislative confidence in the disposition by the agency of particular issues. For example, the degree of "expertise" of a newly formed agency is largely unknowable. The amount of jurisdiction deferred to a new agency may be better left to later judicial determination when the capabilities of the agency are more likely to have been demonstrated.

The courts must decide whether they or the agency will have initial decisionmaking authority through use of the court-made doctrine of "primary jurisdiction."[89] When it feels that issues can be better resolved by the agency, a court might either dismiss the

85 *E.g.*, for applicability to the ICC, *see* Johns, *supra* note 84, at 254-55. For applicability to the CAB, *see* Federal Aviation Act of 1958 § 102, 49 U.S.C. § 1302 (1970). For applicability to bank mergers, *see* Bank Merger Act of 1966, 12 U.S.C. § 1828 (1970).

86 This was a factor leading the *Thill* court to reject arguments for exemption for the securities industry. Thill Securities Corp. v. NYSE, 433 F.2d 264, 272 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

87 *See, e.g.*, S. REP. No. 93-865, *supra* note 79, at 2.

88 BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-5 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

89 3 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 19.01 (1972).

case or retain jurisdiction and suspend proceedings pending administrative determination of all or some issues.[90] The latter alternative is particularly useful when the agency cannot provide the relief available in a district court under the antitrust laws.[91] When the court feels that anticompetitive issues are better decided by the judiciary, it may either decide the case or refer only factual questions to the agency, specifically preserving the legal issues of antitrust violation for de novo judicial determination.[92] If the agency decides issues beyond what the court believes is its proper scope, then the court may refuse to allow any presumption to flow from the agency's judgment.[93]

The third jurisdictional alternative is exclusive judicial jurisdiction. The courts are given sole authority for deciding the factual and legal issues presented. If the agency is not a party in the case before the court, it may be allowed to submit amicus curiae briefs in which its analysis of the factual and legal questions before the court can be given.[94]

B. *Present Judicial Allocation of Decisionmaking Authority*

1. Exemption

Judicial determination of proper decisionmaking roles has been complicated by the separate though related issues of exemption and primary jurisdiction.[95] The Supreme Court examined the

90 For a more precise breakdown of the possible relationships between court and agency jurisdictions and methods of resolving conflicts see Jaffe, *Primary Jurisdiction*, 77 HARV. L. REV. 1037, 1038-40 (1964).

91 The remedies available under the antitrust laws which the SEC could not give include criminal sanctions and treble damages.

92 Ricci v. Chicago Mercantile Exchange, 409 U.S. 289 (1973).

93 This standard of review may be effected either by judicial decision, *see* Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971), or by statutory direction. *E.g.*, Bank Merger Act of 1966, 12 U.S.C. § 1828(c)(7)(A) (1970), which states: "The commencement of such an [antitrust] action shall stay the effectiveness of the agency's approval [of the merger] unless the court shall otherwise specifically order. In any such action, the [district] court shall review de novo all the issues presented."

94 *See, e.g.*, Stark v. NYSE, 346 F. Supp. 217 (S.D.N.Y. 1972), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972); Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

95 The distinction between these two issues must be clearly maintained lest confusion and melding of the issues result. This point is well made in Petruccelli &

exemption issue in *Silver v. NYSE*.[96] In that case Mr. Silver, a non-member broker-dealer, was given provisional approval by the NYSE to maintain wire connections with its members. After a few months the exchange, without giving Silver notice or opportunity to present his case, ordered its members to sever their wire connections with him. Silver's suit against the NYSE included the antitrust charge of concerted refusal to deal and group boycott. The Court discussed the problems and standards in reconciling the antitrust and securities schemes, but decided the case for Silver on the ground that the exchange's actions were a denial of due process for which no justification within the scope of the Exchange Act could be offered.[97] In discussing the exemption issue, the Court avoided a dispositive ruling for the securities industry as a whole. Rather exemption was to be sought on a case-by-case basis: "Repeal [of antitrust laws] is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."[98]

The scope of *Silver*'s exemption analysis is limited.[99] SEC review was not statutorily available to Mr. Silver.[100] Hence, there was no conflict between the antitrust laws and the Commission's regulatory powers,[101] only a conflict between antitrust laws and

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Long, *Antitrust and the Regulated Industries: The Role of the "Doctrine" of Primary Jurisdiction*, 2 U. TOLEDO L. REV. 302 (1969). An example of judicial confusion is Thill Securities Corp. v. NYSE, 469 F.2d 14, 15 n.3 (7th Cir. 1972).

96 373 U.S. 341 (1963).

97 *Id.* at 361-66.

98 *Id.* at 357. The extreme positions of total non-exemption and total exemption were taken by the district court, 196 F. Supp. 209 (S.D.N.Y. 1961), and the court of appeals, 302 F.2d 714 (2d Cir. 1962), respectively.

99 One commentator has characterized the exemption analysis as dictum since the Court could have decided the case solely through its resolution of the final issue—that the due process violations were clearly not within the scope of the Exchange Act. Comment, *supra* note 34. Dictum or not, the exemption analysis has acquired a heavy weight of its own. *See* cases applying the analysis to the securities industry at note 50 *supra*.

100 *See* note 22 *supra*.

101 The SEC lacked authority "to review particular instances of enforcement of exchange rules." Silver v. NYSE, 373 U.S. at 357. In such cases the courts by necessity must be the reconcilers of the competing needs of the antitrust and securities laws. However, even in such cases, the court might wish to seek SEC determination of factual issues of securities industry operation so that the court may better determine what is necessary for the Securities Exchange Act to work. The court could stay its proceedings pending an SEC determination of those limited issues. *Cf.* Ricci v. Chicago Mercantile Exchange, 409 U.S. 289 (1973).

stock exchange powers. *Silver* did not determine the effect of SEC approval of or acquiescence in an exchange rule, or command what district courts should do when their jurisdiction is concurrent with the SEC's.[102] Despite this limitation, the *Silver* exemption analysis has been considered governing law by most lower courts deciding exemption issues where SEC review authority can be plausibly claimed.[103]

The lower courts have not been uniform, however, in their interpretation and application of the *Silver* analysis. Under a "pro-SEC" view, some courts have examined the authorized scope of SEC review. Under a "pro-judiciary" view, other courts haxe examined and weighed the conflicting policies behind the challenged securities activity.

The pro-SEC view is taken by the Second Circuit in *Gordon v. NYSE*.[104] Two alternative interpretations of *Silver* support the pro-SEC view. First, the *Silver* exemption test can be rejected as inapplicable where the SEC has review authority. In *Silver* the Court noted: "Were there Commission jurisdiction and ensuing judicial review for scrutiny of a particular exchange ruling . . . a different case would arise concerning exemption from the operation of laws designed to prevent anticompetitive activity, an issue we do not decide today."[105] The *Gordon* court suggested that existence of SEC review authority alone, because it presents the "different case," could justify a finding of exemption.[106] Second, the *Silver* test can be applied and a finding of exemption still result, on the reasoning that antitrust court intervention in areas of SEC review would inherently disrupt the regulatory scheme of the Exchange Act.[107] In this connection the Commission contends:

> The Securities Exchange Act cannot be expected to work if the district courts may pre-empt the Commission's judgments in areas of its basic regulatory function by rendering ad hoc

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102 373 U.S. at 358 n.12.

103 *See* cases listed in note 123 *infra* and discussion of the conflict in Comment, *supra* note 34.

104 BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

105 373 U.S. 341, 358 n.12.

106 BNA SEC. REG. & L. REP. (No. 261, July 17, 1974), at D-2.

107 *Id.*; *cf.* Stark v. NYSE, 346 F. Supp. 217, 228 (S.D.N.Y. 1972), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972).

> decisions on rules of general application involving the very structure of the securities industry. The unimpaired ability of the Commission to perform its statutory responsibilities is the essence of the statutory scheme.[108]

Under the pro-SEC view, in those twelve areas where the Commission has jurisdiction over the exchange rules under § 19(b),[109] exemption would be granted or strongly presumed.[110]

The opposing view favors judicial decisionmaking in antitrust-securities conflicts. Courts supporting this view have read the *Silver* test to grant only a narrow class of exemptions.[111] To be exempt from antitrust regulation, the challenged securities practice must be both necessary to achieve the goals of the Exchange Act and the least restrictive alternative available for achieving those goals.[112] This pro-judiciary view is politically ascendant. It is held by the subcommittees in both houses of Congress that are charged with examining securities legislation.[113] A number of commentators also support this interpretation of *Silver*,[114] as does

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108 *House Study Hearings, supra* note 58, pt. 7, at 3807 (SEC amicus curiae brief in Jeffries v. NYSE (S.D.N.Y., Civ. No. 71-4542)). *See also id.* at 3947-48 (Milton Cohen, Memorandum to SEC, Dec. 3, 1969).

109 *See* text accompanying note 21 *supra*.

110 William E. Jackson, NYSE counsel, testified that:

> [T]he touchstone of repeal is whether or not the particular activity involved is one over which the SEC has review jurisdiction or not, because, if it does, then for the antitrust laws and the antitrust courts to decide the case would, in effect, oust the SEC of the jurisdiction that Congress intended it should have.

House Study Hearings, supra note 58, pt. 7, at 3748. It should be noted that the Commission has applied this favorable view only to those situations where it has exercised its review jurisdiction. *Id.* at 3948 (Milton Cohen, Memorandum to SEC).

111 *E.g.*, Thill Securities Corp. v. NYSE, 433 F.2d 264, 269-70 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971); Zuckerman v. Yount, 362 F. Supp. 858, 862-63 (N.D. Ill. 1973) (McLaren, J.).

112 *See* Zuckerman v. Yount, 362 F. Supp. 858, 862 (N.D. Ill. 1973) (McLaren, J.). *See generally* Thill Securities Corp. v. NYSE, 433 F.2d 264, 267 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971) ("true necessity").

113 SUBCOMM. ON SECURITIES OF SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. DOC. NO. 93-13, 93d Cong., 1st Sess. 227 (1973) [hereinafter cited as SENATE INDUSTRY STUDY], and SUBCOMM. ON COMMERCE AND FINANCE, HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. DOC. NO. 92-1519, 92d Cong., 2d Sess. 160 (1972) [hereinafter cited as HOUSE INDUSTRY STUDY]. The House Study expressly rejected arguments for the pro-SEC view. *Id.* at 161 n.44.

114 *See, e.g.*, Baxter, *supra* note 5; Johnson, *supra* note 62; Nerenberg, *Application of the Antitrust Laws to the Securities Field*, 6 WEST. RES. L. REV. 131 (1964); Comment, *supra* note 16.

the Antitrust Division of the Justice Department.[115]

A special case applying the pro-judiciary view is *Harwell v. Growth Programs, Inc.*,[116] in which the Fifth Circuit applied *Silver* to an NASD rule interpretation.[117] For 33 years most observers had assumed "that SEC authority over NASD rules, coupled with the express provision in the Maloney Act [§ 15A(n)], would prevent application of the antitrust laws to the NASD."[118] The court held, however, that the antitrust laws could apply to self-regulatory action by the NASD, interpreting § 15A(n) to provide no greater antitrust exemption than the pro-judiciary view of *Silver*.[119]

Harwell's interpretation of § 15A(n) has been rationalized on the ground that the section was only intended to protect the inter-member discount provisions from antitrust attack, and that if Congress had intended to confer general immunity it could have used more precise language.[120] However, § 15A(n) would not be necessary to protect actions authorized by express provision of the Act from antitrust attack. An interpretation of § 15A(n) for that purpose would make the section surplusage. While it is possible that in 1938 Congress intended § 15A(n) to have the same content as the pro-judiciary view of *Silver*, such a possibility is unlikely. Undoubtedly the section was meant to grant greater antitrust immunity than would have been conferred if it did not exist. The

115 *See* McLaren, *supra* note 63, at 188; Antitrust Division Brief in SEC Hearings on Structure of the Securities Markets in *House Study Hearings, supra* note 58, pt. 8, at 3155 [hereinafter cited as Antitrust Div. SEC Submission].

116 451 F.2d 240 (5th Cir. 1971), *cert. denied*, 409 U.S. 876 (1972).

117 *See* discussion of special statutory provisions applying to dealers associations at text accompanying notes 30-43 *supra*.

118 Recent Decisions, *Application of the "Silver Test" is Necessary Before Exempting the National Association of Securities Dealers from the Antitrust Statutes — Harwell v. Growth Programs*, 23 SYRACUSE L. REV. 956, 960 (1972).

119 451 F.2d at 247. The extent of SEC supervision over the NASD action was not apparent in the record before the court. *Id.*

120 Comment, *supra* note 34, at 130-31. For other, more precisely worded statutory antitrust exemptions, *see* Clayton Act, 15 U.S.C. § 18 (1970) (exemption from merger limitations for "transactions duly consummated pursuant to authority given by" the SEC under the Public Utility Holding Company Act, the CAB, FCC, FPC, ICC); Webb-Pomerene Act, 15 U.S.C. § 62 (1970) (exemption from Clayton Act §§ 1-7 for certain export associations); Shipping Act, 46 U.S.C. § 814 (1970) (exemption for rate schedules approved by the Federal Maritime Commission); Interstate Commerce Act, 49 U.S.C. § 5 (1970) (exemption for ICC approved transactions); Federal Aviation Act, 49 U.S.C. § 1384 (1970) (exemption for acts approved by the CAB).

vague wording of the section would indicate that rather than embodying a specific substantive standard, it was intended to grant an increment of antitrust exemption which the rest of the Securities Exchange Act did not enjoy. Since the *Silver* test would apply to the Maloney Act if § 15A(n) were not in the statute, the congressional purpose for including the § 15A(n) antitrust exemption must have been to confer an increment of immunity greater than that in *Silver*. That additional immunity could very well be sufficient to equal the Second Circuit's pro-SEC view of the *Silver* test.

Exemption for securities industry practices has generally been difficult to secure. It has been denied for the anti-rebate rule[121] and for an extension of the anti-rebate rule to an interim service charge.[122] Fixed minimum commission rates have met a mixed fate.[123] Restrictions on membership to exclude institutional exchange members may be exempt.[124]

2. Primary Jurisdiction

If a statutory exemption is found, then the work of the antitrust court is completed. The court's role is reduced to normal administrative review. If an exemption is not found, then the court must confront the issue of primary jurisdiction.[125]

In *Silver* the Supreme Court did not decide primary jurisdiction since the SEC lacked jurisdiction over the contested application of exchange rules. The Seventh Circuit, through Chief Judge Swygert's concurrence in *Thill Securities Corp. v. NYSE*,[126]

121 Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

122 Jacobi v. Bache & Co., 377 F. Supp. 86 (S.D.N.Y. 1974).

123 *Compare* Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304) (exemption with judicial requirement of SEC consideration of competitive factors) *and* Kaplan v. Lehman Bros., 371 F.2d 409 (7th Cir. 1967), *cert. denied*, 389 U.S. 954 (1967) (as limited by the *Thill* court, 433 F.2d 264 (1970), *cert. denied*, 401 U.S. 994 (1971)) (exempt only from a per se finding of violation), *with* Frederickson v. Merrill Lynch, BNA SEC. REG. & L. REP. (No. 271, Oct. 2, 1974) D-1 (N.D. Ill. Sept. 9, 1974) (not exempt).

124 Stark v. NYSE, 346 F. Supp. 217 (S.D.N.Y. 1972) (dictum), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972).

125 Actually this term misleads because it implies virtually an "either-or" decision on jurisdiction (either courts or the agency will decide the issues presented) and fails to reflect the variety and gradations of jurisdictional deference.

126 433 F.2d 264, 275 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

pointed to the issue and listed factors relevant to a primary jurisdiction determination, but reached no conclusions on the question. One court to rule on the primary jurisdiction issue decided not to defer to the SEC on a challenge to the minimum fixed commission rates.[127] After considering the *Thill* factors, the court noted that "the present is the type of dispute which is appropriate for the invocation of the doctrine of primary jurisdiction."[128] Nonetheless the court refused to defer to SEC jurisdiction because the Commission had sanctioned the challenged activity by inaction.[129] Another court rejected primary jurisdiction deference to the SEC on a challenge to application of the anti-rebate rule to an emergency service charge on the grounds that the SEC declined to decide the issue, and that the "focus of the challenge . . . [was] in the sphere of the courts' particular antitrust competence . . . ."[130]

C. *Functional Analysis of Appropriate Decisionmaking Roles*

The legislative choice of jurisdictional scheme should result from a pragmatic determination that a particular allocation of authority and degree of interaction between the courts and the SEC will lead to the best resolution of the conflicting policies.[131] This article proposes allocation based on the procedural issues common to antitrust-securities cases and examines the influence of procedural roles on the substantive outcomes.[132] An alternative

127 Frederickson v. Merrill Lynch, BNA SEC. REG. & L. REP. (No. 271, Oct. 2, 1974) D-1, D-3 (N.D. Ill. Sept. 9, 1974).

128 *Id.*

129 *Id.*

130 Jacobi v. Bache & Co., 377 F. Supp. 86, 93 (S.D.N.Y. 1974).

131 The judicial decision of primary jurisdiction should be the same inquiry except that the court is theoretically bound by the prior legislative determination of the exemption issue. However, the exemption issue is also open to pragmatic inquiry. The *Silver* test of exemption invites a judicial inquiry into current practicalities of exemption. And some commentators have included among the judicial choices of primary jurisdiction schemes a scheme called "preclusive-primary jurisdiction," which is equivalent to exemption except that the reviewing court requires consideration of anticompetitive factors. *E.g.*, Ginsburg, *Antitrust Laws and Stock Exchanges, The Minnesota Commission: A Jurisdictional Analysis*, 24 U. MIAMI L. REV. 732, 751-58 (1970). The Second Circuit has adopted this latter approach. *See* text accompanying note 86 *supra.* Thus the primary jurisdiction and exemption inquiries are largely open to pragmatic analysis by the courts.

132 *See, e.g.*, Stokes, *supra* note 81. *See also* the functional analysis in Note, *Primary Jurisdiction in Antitrust Action Against the New York Stock Exchange: Immunization and Expertise*, 1970 U. ILL. L. FORUM 544, 564-570.

approach might be the allocation of roles based on the substantive issues of each case rather than the procedural issues common to all cases.[133] Decisionmaking roles would vary according to the issues presented in each case. However, altering decisionmaking roles based on the substantive issues of each controversy would lead in every case to uncertainty as to who decides what the decisionmaking roles are, unpredictability as to the prime decisionmaking forum, and endless confusion about the procedural relationships between the SEC and the courts. A scheme of authority that does not fluctuate with the issues of each case seems more desirable, and is therefore examined here.

1. Relative Responsiveness to Antitrust-Securities Policies

The Commission's review of exchanges' actions have been criticized as secret and informal. And pressures created by private antitrust actions have been claimed as the only reason for the Commission's recent burst of antitrust enthusiasm.

Critics have characterized the SEC's regulatory procedures as being informal, confidential, and highly discretionary.[134] Rather than expressly approving or disapproving an exchange rule, the Commission often informally negotiates[135] with the NYSE to arrive at a rule acceptable to parties. For example, in 1966 the SEC and the NYSE reached a compromise solution for changes in Rule 394 restricting member off-floor trading. Only after the final decision had been reached did the SEC open the rule to public comment.[136] A month later, with no discussion, the changes were

133 For example, the degree of centrality or importance of a contested securities practice to the scheme of securities regulation does affect the inclination of the courts to assume authority for deciding the legitimacy of the controverted practice. For "peripheral" securities practices, a greater judicial decisionmaking role will be less disruptive of securities regulation and may be desirable. *Compare* Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-5 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304) (fixed commission rates exempt though anti-rebate practices might not be because the former were in "the core of antitrust immunity") *with* Jacobi v. Bache & Co., 377 F. Supp. 86, 92-93 (S.D.N.Y. 1974) (anti-rebate rule applied to emergency service charge "fell only partially within the regulatory function of the Commission" and was therefore not exempt).

134 Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J. 811 (1971).

135 Securities Exchange Act of 1934 § 19(b), 15 U.S.C. § 78s(b) (1970), specifies areas of exchange self-regulation over which the SEC has review.

136 Note, *supra* note 134, at 823-24.

sent to the NYSE in the form of a § 19(b) request.[137] In 1968 the SEC approved commission rate increases after public hearings, but the resolution of important issues was still left to private negotiations.[138]

This criticism of the SEC may exaggerate the implications of the informal relationship between the Commission and the exchanges.[139] Among the primary objectives of administrative regulation are flexible review of industry practices and expedited implementation of agency policy.[140] As long as the Administrative Procedure Act is not violated, these informal proceedings might enable the SEC to make appropriately necessary adjustments in exchange policy with a minimum of delay.[141]

A more weighty criticism of SEC responsiveness to antitrust concerns is that Commission action in this area has only come under pressure from private antitrust litigation. It was not until after *Silver* raised the specter of antitrust actions that the NYSE welcomed SEC review of its rate structure.[142] When the SEC considered the 1968 changes in the NYSE rate structure, it was Antitrust Division insistence that led the Commission to call public hearings.[143]

This historical absence of meaningful SEC regulation of anticompetitive matters must be evaluated in light of several mitigat-

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137 The NYSE asked the Commission to put the changes in the form of a § 19(b) (codified at 15 U.S.C. § 78s(b) (1970)) request in order both to establish a formal groundwork for an antitrust exemption and to assuage disgruntled members. *Id.* at 824. Even when the Commission forces the NYSE to alter restrictive practices, the final changes are often minor. The 1966 amendments to Rule 394, for example, preserved the core of that rule. *Id.* at 825. Furthermore, the "SEC has done little to regulate the Exchange to make the new rule achieve its professed purposes." *Id. See* Note, *Fixed Brokerage Commissions*, *supra* note 53, at 819-20.

138 Note, *supra* note 134, at 831. The Yale Note concluded that despite recent emphasis on more open proceedings, "the informal pattern has remained unchanged." *Id.* Secret negotiations led to SEC approval of a surcharge on small transactions. *Id.* at 829.

139 Criticism of the informality of SEC review might be more relevant to the question of whether SEC procedures are fair to interested parties seeking review of self-regulatory acts. *See* text accompanying notes 181-219 *infra*.

140 L. JAFFE & N. NATHANSON, ADMINISTRATIVE LAW: CASES AND MATERIALS, 5, 21-22 (3d ed. 1968).

141 *S. 2519 Hearings*, *supra* note 11, at 69-71 (testimony of Ray Garrett).

142 *See* Note, *supra* note 134, at 826. Even as late as 1965, Jennings noted that "[o]ne of the curious aspects of the current controversy [over minimum commission rates] has been the inactivity of the Securities and Exchange Commission." Jennings, *supra* note 55, at 171.

143 Note, *supra* note 134, at 828.

ing factors. First, the 1934 Act and the legislative history are directed toward eliminating destabilizing and fraudulent rather than anticompetitive practices. Second, the lack of standards directed clearly toward anticompetitive behavior leaves the SEC with a less than obvious claim for considering it.[144] Third, anticompetitive practices existing at the time of the 1934 Act (notably fixed commission rates) were not prohibited by the Act despite discussion of some practices in the legislative hearings on the Act.[145]

Whatever the reasons, the SEC has become more responsive to anticompetitive factors in recent years. During the 1960's the SEC's supervisory role was revitalized.[146] Review procedures have also been improved.[147] In 1969 the Commission announced that it would consider anticompetitive factors in reviewing self-regulatory activity.[148] These factors are evaluated within the public interest and investor protection standards of the Act. According to the SEC, its decision to abolish fixed rates[149] underscores the SEC belief that competitive concerns are of fundamental importance in designing the future securities market.[150] And the Commission claims that SEC actions criticized by the Antitrust Division have been taken only after thorough analysis of the anticompetitive consequences.[151] SEC antitrust cognizance has also been recognized by some courts which have deferred to the Commission's judgments.[152]

144 The courts have recently recognized the SEC's authority to consider anticompetitive factors. *See, e.g.*, Thill Securities Corp. v. NYSE, 433 F.2d 264, 271-72 (1970), *cert. denied*, 401 U.S. 994 (1971).

145 *See, e.g.*, the discussion of legislative history in Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-3 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

146 Note, *supra* note 132, at 556-57.

147 *See* SEC SECURITIES STUDY, *supra* note 14. The Commission adopted Rule 17a-10 requiring detailed information about broker-dealers to be filed so that it would not need to rely on NYSE-prepared statistics. It also adopted Rule 17a-8 requiring the exchanges to file proposed rule changes with the Commission before the rule becomes effective.

148 Securities Exchange Act Release No. 8339 (January 26, 1969).

149 Securities Exchange Act Release No. 10,383 (September 11, 1973).

150 *See S. 2519 Hearings, supra* note 11, at 73-75 (testimony of Ray Garrett). "[W]e [have] committed ourselves firmly to a market system that would offer the greatest advantages of competition to all public investors, in an effort to make our markets more efficient and to increase confidence in the securities markets." *Id.* at 73.

151 *See Hearings on S. 470 & S. 488 Before Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 93d Cong., 1st Sess. 193-214 (1973) (SEC Release on 19b-2) [hereinafter cited as SEC Release on 19b-2].

152 *See, e.g.*, Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974)

Despite the SEC's recent willingness to act upon anticompetitive concerns, many still question its commitment to aggressive, unbiased review. This skepticism has been voiced by commentators,[153] the Seventh Circuit,[154] and in Congress.[155] Former Congressman Emanuel Celler indicated his belief that anticompetitive exchange practices remain uninhibited by the SEC:

> All indications, then, are that the [New York Stock] exchange, not insulated from antitrust liability, has consistently violated antitrust principles . . . . We have no proof other than pretense and sham and folderal that it does not still remain, and intends to remain, untolerably [*sic*] a law unto itself.[156]

The fact that antitrust suits might have spurred the SEC to consider anticompetitive factors is only relevant if one believes that the Commission would revert to the pre-*Silver* situation if it were vested with greater decisionmaking authority. But in the last decade anticompetitive concerns have become one of the public interest criteria which the Commission evaluates in reviewing self-regulatory activity.[157] Also, if the statutory standards of SEC review are amended expressly to include competitive factors[158] or if the statutory standards are judicially interpreted to require consideration of competitive factors,[159] Commission treatment of those factors would be subject to judicial analysis on appellate review. With this safeguard it seems unlikely that the Commission could slip into its earlier pattern of minimal concern for competitive arguments.

There is also a risk that antitrust courts will be overly concerned with applying the competitive model of the antitrust laws and unfairly discount policies of non-competitive importance. In-

D-1, D-3 to D-4 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

153 *See, e.g.*, Comment, *supra* note 9, at 295.

154 Thill Securities Corp. v. NYSE, 433 F.2d 264, 273 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

155 *See, e.g.*, HOUSE INDUSTRY STUDY, *supra* note 113, at 163; SENATE INDUSTRY STUDY, *supra* note 113, at 238. Agencies "tend to be too concerned with the economic welfare of the industry in their charge." *Id.*

156 *House Study Hearings*, *supra* note 58, pt. 3, at 1645.

157 Securities Exchange Act Release No. 8339 (January 26, 1969). *See* Municipal Electric Ass'n v. SEC, 413 F.2d 1052 (D.C. Cir. 1969) (anticompetitive considerations are among the public interest factors which the SEC must consider in approving a merger under the Public Utilities Holding Company Act).

158 *See* Williams Bill, *supra* note 17, § 18.

159 Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

stead of objectively balancing the interests involved, the court might unduly dwell on the anticompetitive aspects of the challenged action.[160]

Antitrust courts may also be insensitive to the interdependence of practices directed toward a single yet complex long-run goal. The creation of a national securities market system is an excellent example where interference in one area by judges unsophisticated in the overall operation of securities markets could defeat the entire project. Increasingly, the focus of SEC activity[161] and congressional inquiry[162] is the establishment of a central or national securities market system. The system is designed to improve the ability of American securities markets to attract investment capital by centralizing the capacities and resources of the securities markets.[163] A uniform system of communication tying together sales and quotation information from the various markets will tell buyers and sellers where they can secure the best possible executions of their orders.[164] In addition, to facilitate access to the different markets by buyers, sellers, and brokers, several restraints on trade would be eliminated or reduced.[165] Creating a central market system requires establishing a coordinated transition by many diverse securities industry participants on many different topics. The SEC should have flexibility for experimentation to determine the effect of its innovations.[166] Sudden, drastic changes in industry practices due to antitrust court judgments could counterproductively impede the orderly transition of a fractionalized industry to a more competitive and more resourceful industry.

2. Relative Decisionmaking Capabilities

a. Fact-Gathering and Analytical Capabilities and Experience

Since the antitrust regulatory system is grounded in judicial enforcement, the courts are assumed to possess the appropriate

160 Note, *supra* note 132, at 564-65.
161 *See SEC CMS Statement, supra* note 70.
162 *See, e.g.*, S. REP. No. 93-865, *supra* note 79.
163 *Id.* at 3-4.
164 *Id.* at 4.
165 *See SEC CMS Statement, supra* note 70, at D-3, D-14.
166 One such experiment has been the recent removal of fixed commissions from very small transactions. Merrill Lynch's reduced rates were one surprising result of the experiment.

experience, skill, and judgment to administer the antitrust laws properly. This assumption of judicial expertise has frequently been extended without analysis to include antitrust-securities conflicts. As Judge Campbell wrote in *Thill,* "Congress and our Supreme Court have directed the courts to employ this expertise unless the court in a given case concludes that its employment will frustrate the goals of the regulatory scheme."[167] Without analyzing the SEC's capabilities, the Senate subcommittee studying the industry concluded that Congress intended for the courts to exercise antitrust judgment in place of the SEC.[168] The House subcommittee expressed the same conclusion, contending that since the Commission lacks antitrust expertness, "it would be an egregious anomaly to give great weight to the decisions of the less expert tribunal [the SEC], and restrict the decisional power of the more expert tribunal [the courts]."[169] Allocation of decisionmaking roles should be based on an analysis of the relative capabilities of the two forums rather than an imposition of preconceptions of one regulatory scheme where two regulatory schemes conflict.

A suit against a self-regulatory securities organization is significantly different from a normal antitrust case in two respects. First, unlike many antitrust cases, the existence of a restraint of trade is readily admitted. District court expertise in discerning trade restraints is irrelevant to antitrust challenges to self-regulation. Second, antitrust doctrines of per se liability are inapplicable to antitrust-securities conflicts. After the court decides that a specific activity is unnecessary for the operation of the Exchange Act, the challenged restraint of trade must be examined by the test of "reasonableness."[170] Determining "reasonableness" necessitates value judgments and policy decisions about the operation of the securities industry.

The court is not only without standard per se guideposts but must evaluate complex securities industry policies. Making fundamental decisions on the future of the securities market requires the compilation, analysis, and evaluation of tremendous amounts

167 Thill Securities Corp. v. NYSE, 433 F.2d 264, 273 (7th Cir. 1970), *cert. denied,* 401 U.S. 994 (1971).

168 SENATE INDUSTRY STUDY, *supra* note 113, at 238.

169 HOUSE INDUSTRY STUDY, *supra* note 113, at 166.

170 Silver v. NYSE, 373 U.S. 341, 360 (1963).

of data.[171] Courts lack the ability and facilities to initiate fact-gathering,[172] and the rules of evidence may pose some undesirable barriers. While antitrust courts are accustomed to processing huge volumes of evidence, reliance on the courts' fact-processing may be unwise when the issue of reasonableness is treated as a question of fact submitted to a jury.[173] As Judge Hoffman concluded, "Courts are ill-equipped to handle technical securities industries matters."[174]

In contrast, the SEC has the advantage of initiating the collection of more comprehensive, up-to-date, and innovative data. And the Commission's staff, investigative resources and flexible procedures for admitting evidence are better designed for processing data toward formulating policy conclusions of the complexity of antitrust-securities questions.[175] To be sure, the SEC's ability to evaluate anticompetitive acts has been questioned. It is contended that the Commission is more experienced with questions of fraud, deception, and financial solvency than with industry restraints of trade.[176] Yet the extensive consideration which the Commission

171 *See, e.g.*, the *House Study Hearings*, *supra* note 58, which covered 4,623 pages.

172 *See* Note, *supra* note 74, at 578. Courts are dependent on the facts presented by the parties or of which they may take judicial notice. The healthy operation of the securities markets might be too vital to leave to the uncertain presentation by the adversary system of information, issues, and alternatives.

173 For a caricatured view of antitrust juries in the context of a criminal case:

> Not the least of the oddities in this courtroom was the bleary-eyed jury of fifteen . . . . Prohibited . . . from making notes on the fantastically elaborate cases for both prosecution and defense . . . they were supposed to keep straight in their heads the material which the lawyers could organize only with the help of staffs or trained assistants. . . . The entire situation was a brilliant reductio ad absurdum [*sic*] of the jury system or of the imposition of criminal penalties on violation of the . . . antitrust statutes, or of both."

M. MAYER, THE LAWYERS 322 (1966).

174 Kaplan v. Lehman Bros., 250 F. Supp. 562, 566 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir. 1967), *cert. denied*, 389 U.S. 954 (1967); *cf.* Gordon v. NYSE, 366 F. Supp. 1261, 1264-67 (S.D.N.Y. 1973).

175 *See* Note, *supra* note 132, at 557-59.

176 *See* Thill Securities Corp. v. NYSE, 433 F.2d 264, 273 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971), Antitrust Div. SEC Submission, *supra* note 115, at 3156. Yet to prevent manipulation, SEC investigators must be thoroughly familiar with the intricate operations of the industry. The rules dealing with manipulative and deceptive devices and contrivances are of a highly technical nature. Rules 10b-1 to 10b-17, 17 C.F.R. §§ 201.10-201.19. *See generally* SEC SECURITIES STUDY, *supra* note 14.

> With [the SEC's] broad responsibilities and concern for the entire area it is in the best position to comprehend and reconcile . . . the diverse

has recently given anticompetitive issues, combined with its familiarity with the industry, appear to give the Commission as much, if not more, experience with securities industry competitive affairs as that possessed by any district court judge.[177]

b. Utilization of the Expertness of the Other Forum

District courts might be able to utilize SEC expertness and opinions when the Commission files amicus curiae briefs setting out its analysis and conclusions on the problems at issue. In this way the court might benefit from the Commission evaluation without having to relinquish jurisdiction.[178] The use of amicus briefs has encouraged a certain rivalry between the SEC and the Antitrust Division. When the two agencies submit briefs urging alternative dispositions of the case, the court may be edified by two different, experienced, and valuable opinions. Thus, the likelihood of a well informed outcome might be increased.[179] Yet the time span available for submission of a brief by the rivals may be too short for the SEC or the Antitrust Division to investigate, collate, consider, and submit in-depth data and thoughtful analysis of complex securities industry considerations.

The SEC can also benefit from the antitrust experience of the Antitrust Division. The Division, whose experience with these problems is broader than that of any single judge, can submit its opinions to the SEC.[180] Such opinions can be highly useful to the

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> factors and considerations that may constitute or bear upon the total public interest in the manifold and complex circumstances where the question may arise. This is true of questions of competition and all other aspects of the public interest, as well as question of reconcilement of private interests.

Id. pt. 4, at 707.

177 *See* Kaplan v. Lehman Bros., 250 F. Supp. 562, 566 (N.D. Ill. 1966); Note, *Antitrust Laws and the Securities Exchanges*, 66 NW. U. L. REV. 100, 113 (1971); Note, *Stock Exchange Immunity From the Antitrust Laws*, 51 B.U.L. REV. 32, 52 (1971).

178 *See* Ginsburg, *supra* note 131, at 761.

179 Of course, an opposite result might occur when a judge, unfamiliar with the industry, is confused by two disinterested, expert, but opposing opinions on the issue.

180 *E.g.*, Antitrust Div. SEC Submission, *supra* note 115, at 3135 *et seq.* *Cf.* requirement that, prior to approval of bank mergers by the appropriate bank agency, the Attorney General and other banking agencies submit reports on competitive factors. Bank Merger Act of 1966, 12 U.S.C. § 1828 (1970).

Commission, especially if it is required to consider and comment upon anticompetitive factors in its decision. Such submissions also provide a reviewing court with a ready contrast against which the agency's decision can be tested.

3. Protection of Adversely Affected Individuals

The decision on which tribunal should initially resolve antitrust problems should reflect not only their relative capabilities but also how fairly each forum treats individuals who may be adversely affected by its decisions.

a. Ability to Require Review of Self-Regulatory Decisions

Though the SEC has authority to review NASD disciplinary actions, it lacks such review authority over the specific applications of exchange rules. Hence an exchange-disciplined party can challenge the action only in a court for violation of antitrust or due process protections. If due process has been provided, the antitrust plaintiff must show that the exchange discipline was an unreasonable restraint of trade.[181] The antitrust court may be an inadequate forum to review many disciplinary proceedings. The plaintiff's challenge can be based only on competitive harm rather than harm suffered to securities policy interests. For the antitrust defendant, justifications for the challenged practice must be evaluated under one vague criterion — reasonableness. SEC review of disciplinary proceedings would allow a broader evaluation of the harms suffered and a more structured analysis of the justifications for discipline. If the Commission is given review authority over exchange disciplinary actions, the question arises whether the disciplined party may compel its exercise.[182] The severe effect which exchange sanctions can have on disciplined businesses and individuals would argue that a right of appeal to the SEC be granted.

At another level, the SEC may be able to review the rule itself rather than await a particular instance of its enforcement. Rules of the NASD can be reviewed regardless of subject matter.[183]

181 *See* note 170 and accompanying text *supra.*

182 Review can be required by an affected party for disciplinary action by the NASD. 15 U.S.C. § 78o-3(g) (1970).

183 *See* note 38 *supra.*

Rules formulated by the exchanges can be reviewed only if they fall within the twelve topics of § 19(b). Although these topics seem to encompass directly or by implication almost all phases of exchange rules, SEC uncertainty about the scope of its authority may discourage Commission review of some exchange rules.

Under the Securities Exchange Act, an interested party cannot require the Commission to review self-regulatory rules even where SEC authority exists. SEC review of such rules may be best left to SEC discretion.[184] The alternative is to allow one party out of the hundreds perhaps thousands affected to invoke time-consuming and costly rulemaking proceedings. Moreover, if SEC review of disciplinary proceedings is made mandatory, an interested party could force review by violating the rule and risking the self-regulator's discipline. The disciplinary action would then be reviewed mandatorily by the party's petition to the SEC. Placing this burden on a party interested in review of a self-regulator's rule may be a necessary counterweight to prevent constant rule-review proceedings.

b. Formal and Open Deliberations

The adversarial format for judicial adjudications of antitrust-securities issues leads to very formal and open proceedings. The SEC feels that the need for formal proceedings over exchange rules should be determined in each case after balancing the benefits of public participation against the desirability of having frank, uninhibited, and hence informal discussions with the industry.[185] It has been suggested that the Commission might simply not object to an exchange rule it approves, thereby obviating the need for formal proceedings.[186] Such passive deliberation prevents an interested party from adequately airing his grievance.[187]

Requiring formal deliberations helps to preclude improper collusion of the agency and the industry and to assure that affected parties can meaningfully participate by challenging all evidence

184 SENATE INDUSTRY STUDY, *supra* note 113, at 97 (SEC statement on S. 2519).

185 *Senate Study Hearings*, *supra* note 25, pt. 3, at 21 (statement of Philip A. Loomis, Jr.).

186 *House Study Hearings*, *supra* note 58, pt. 7, at 3763 (Memo from NYSE Counsel).

187 SENATE INDUSTRY STUDY, *supra* note 113, at 225-26.

before the agency. The collusive dangers of informal deliberations seem most unfair in cases of adjudications where individual members of the industry receive focused treatment. Informal SEC proceedings should not be allowed for review of adjudications by self-regulators.

However, many SEC decisions are more policy-oriented than adjudicatory. Confidentiality of staff reports[188] generally might protect the Commission's flexibility since premature publicity could hamper compromise and changes in formulating a final policy. Yet even in policy formulations, formality and openness help prevent improper influence and assure that all information before the Commission can be tested through challenge.[189] If the Commission exercises initial decision authority over antitrust-securities disputes, interested persons should be entitled to formal proceedings and be allowed to examine and comment upon all information considered by the SEC.

c. Clarity of Antitrust Standards

Since the 1934 Act does not expressly define antitrust standards for the Commission review,[190] anticompetitive concerns are now judged under the agency's public interest and investor protection criteria.[191] The Commission has not issued precise standards for its evaluation of exchange trade restraints.[192]

The Antitrust Division has urged that SEC decisions must follow the pro-judiciary *Silver* interpretation.[193] Under this view the Commission should not approve restrictive self-regulatory acts unless the actions are no more restrictive than is absolutely necessary to meet the specific goals of the Exchange Act. But self-regulation without undue trade restraints inevitably must be achieved by trade-offs. The anticompetitive standards must be sufficiently flexible to allow the necessary choices. Strict applica-

188 Some SEC records on antitrust issues in policy formulations have been kept secret. *E.g.*, the SEC refused to make public a 1966 Staff Study condemning Rule 394. Only the NYSE was given a copy of the report. Note, *supra* note 134, at 822-23.

189 *Cf.* Moss v. CAB, 430 F.2d 900 (D.C. Cir. 1970).

190 *See* text accompanying note 21 *supra*.

191 SEC Release on 19b-2, *supra* note 151, at 196.

192 *Id.* at 195; Note, *supra* note 53, at 823 n.161; *cf.* note 132 *supra*.

193 Just. Dept. PBW Brief, *supra* note 10, at 200.

tion of the pro-judiciary view of *Silver* is therefore impractical. Moreover, proving that the practice is no more restrictive than necessary will be extremely difficult given the ill-defined goals of the Exchange Act.

However, any variation from the antitrust standards of "necessity" and "least restrictive alternative" necessarily dilutes the antitrust protection afforded interested parties. Milton Cohen has argued that in reviewing restrictive exchange rules the Commission should have the flexibility to endorse the most effective approach. He believes that Commission decisions need only be "appropriate and adequate" within the framework of the Exchange Act, rather than "necessary" to make the Act work.[194] The Cohen standard is not an anticompetitive standard. Instead it would allow full play for securities industry policies, thereby substantially reducing antitrust safeguards.[195]

The need to protect the competitive concerns of interested parties requires some modification of the "appropriate or adequate" test suggested by Mr. Cohen. But the strict Antitrust Division criteria would unduly damage the securities industry's interests. A more appropriate resolution might require SEC consideration of anticompetitive effects yet allow greater or lesser weight to be given to anticompetitive concerns as other goals of the securities laws come into play.

It should be noted here that the courts also lack clear antitrust standards for the securities industry. The "reasonableness" test requires an examination of all the circumstances, necessarily including Exchange Act values. The courts therefore have, at least in this area, no advantage over the SEC.

d. Articulation of Reasons for Decisions

In judicial antitrust proceedings, evidence is provided in the record for evaluation on appeal. Some observers have demanded no less of the Commission.[196] Requiring a statement of the facts

194 *House Study Hearings, supra* note 58, pt. 8, at 3948-49 (Milton Cohen, Memorandum to SEC, Dec. 3, 1969); *see also S. 2519 Hearings, supra* note 11, at 81 (SEC Comments on S. 2519).

195 *See* Kestenbaum, *Primary Jurisdiction to Decide Antitrust Jurisdiction: A Practical Approach of Functions*, 55 GEO. L. REV. 812, 817 (1967).

196 Bicks, *Antitrust and the New York Stock Exchange*, 21 BUS. LAW. 129, 153

on which the agency relies and limiting SEC consideration to facts adduced from the record would facilitate judicial review, since appellants could then more easily dispute the basis of a Commission decision.

The SEC believes such a requirement would be burdensome because to formulate general policy it relies on the judgment it has developed through a familiarity with the industry.[197] Commissioners are expected to utilize such "legislative facts" which, by their very nature, do not appear in the record.[198] But SEC is fully capable of holding wide-ranging hearings and articulating both its reasoning and the general facts on which it rests.[199] Compared with the interest of assuring meaningful judicial review for affected parties, the increased burden placed on the Commission by this requirement appears reasonable.

e. Adequacy of Relief

In an antitrust court, violations are subject not only to equitable relief, but also to damages (both compensatory and punitive) and criminal sanctions.[200] Where the Commission determines that an exchange rule is too restrictive for the public interest, the only authority it has under the Exchange Act is "by rules, regulations, or by order to alter or supplement the rules of such exchanges (insofar as necessary or appropriate to effect such changes)."[201] This power falls considerably short of the extensive civil and criminal remedies of the antitrust laws.[202]

To the extent that Commission sanctions are less than judicial remedies, the interests of aggrieved individuals and the public in general[203] are sacrificed. While not all antitrust remedies are ap-

(1965). *See* H.R. 5050, 93d Cong., 1st Sess. §§ 202, 206 (1973); Williams Bill, *supra* note 17, § 18.

197 *Hearings on H.R. 5050 Before Subcomm. on Commerce and Finance, House Comm. on Interstate and Foreign Commerce*, 93d Cong., 1st Sess. 475-76, 483 (1973) (testimony of Philip A. Loomis, Jr.).

198 *Id.*

199 *E.g.*, SEC Release on Rule 19b-2, *supra* note 151, at 193.

200 Sherman Act §§ 1-4, 15 U.S.C. §§ 1-4 (1970); Clayton Act § 3, 15 U.S.C. § 15 (1970).

201 Securities Exchange Act of 1934 § 19(b), 15 U.S.C. § 78s(b) (1970).

202 *See* Comment, *supra* note 16, at 321.

203 Although it seems unlikely that the government would seek criminal sanctions against officials of the exchanges or its members, the possibility exists.

propriate in the context of self-regulation, persons damaged by unduly restrictive acts have a legitimate interest in being compensated.[204] Therefore, district court participation in the process of applying antitrust remedies to the security industry must be maintained in some form.[205]

f. Judicial Review

Greater Commission initial decision authority in the antitrust field could not fairly protect interested parties unless its decisions were subject to appellate review. Appellate review of SEC oversight of anticompetitive self-regulatory acts would assure fair treatment of aggrieved parties both by giving them a forum[206] to challenge Commission decisions and by providing a safeguard against inactivity or bias.[207]

A real problem in obtaining review is the unappealable nature of many Commission deliberations because they do not lead to final orders.[208] Congress has expressed concern about the seem-

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204 *See* Jaffe, *supra* note 90, at 1055. "The statute [Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78(a) (1970)] has deliberately saved and provided judicial remedies, and they should not be sacrificed to the doctrine of primary jurisdiction beyond what is necessary to achieve its basic purpose." *Id.*

205 Interestingly, in some situations the SEC will be able to provide remedies where antitrust courts are powerless. Because of the statutory language, courts are denied antitrust jurisdiction over some types of anticompetitive behavior. But an SEC with a mandate of considering anticompetitive factors would theoretically not be so limited. For example, alleged price discriminations are not within the reach of the Robinson-Patman Act because mutual fund shares are not "commodities." Baum v. Investors Diversified Services, Inc., 409 F.2d 872 (7th Cir. 1969). Other examples are given in Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-2 n.7 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

206 Interested parties would probably have sufficient standing to obtain appellate review if they had been aggrieved by the Commission proceedings. Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a) (1970) states: "Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such a person is a party may obtain a review of such order in the Court of Appeals . . . ." So long as the interested person had been a party to the SEC proceedings he would have standing to obtain review. *See* 2 L. Loss, *supra* note 13, at 1317 n.105.

207 *See* Note, *supra* note 132, at 565.

208 § 19(b) letters of suggestion might be unreviewable because they are not final orders. Justice Department Post-Trial Brief in Thill Securities Corp. v. NYSE (E.D. Wisc., filed January 13, 1972) at 12-14 [hereinafter cited as Just. Dept. Post-Trial *Thill* Brief]. *Cf.* Kixmiller v. SEC, 492 F.2d 641 (D.C. Cir. 1974) (Commission refusal to review a staff "no action" letter was not a final SEC determination). *But cf.* Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972) (Commission approval of staff's "no action" letter constituted a final order and was therefore reviewable).

ingly unreviewable nature of SEC informal review of exchange rules where the Commission acquiesces to the exchange rule without expressly approving the action in question.[209] If SEC informal decisions on antitrust issues are given decisive weight, many affected persons would be denied both a de novo antitrust challenge and appellate review of Commission action.[210] While informal SEC review facilitates the exercise of its § 19(b) authority, appellate courts should not be excluded from protecting the basic antitrust interests of aggrieved parties.[211]

Since Exchange Act § 25(a) says that only SEC "orders" are reviewable, the issuance of restrictive rules or regulations under § 19(b) might also be unreviewable.[212] These would probably be quasi-legislative rules of general application, even though some parties would be affected more than others. Neither the 1934 Act nor the Administrative Procedure Act gives a court of appeals jurisdiction to review the promulgation of such rules.[213] Since the SEC presently lacks authority to review the enforcement of exchange rules, when the § 19(b) rule is eventually enforced by the exchanges there will be no opportunity for the Commission to issue an "order" concerning it. Thus, appellate review of § 19(b) rules might never be obtainable. A person aggrieved by an SEC policy would therefore be denied this protection and de novo antitrust attack might be his only way into court. Similarly, where the SEC lacks decisionmaking authority,[214] refuses to consider a controversy, or unreasonably delays proceedings, then de novo judicial antitrust action is necessary.

If judicial review is obtained the standard of review must be decided. Both the Administrative Procedure Act and the Exchange Act provide that Commission determinations of "facts" are conclusive if supported by substantial evidence.[215] The basic antitrust

209 SENATE INDUSTRY STUDY, *supra* note 113, at 219-20.

210 This is the "double bind" referred to in footnote 13 of the Just. Dept. Post-Trial *Thill* Brief, *supra* note 208, at 26.

211 *See* text accompanying notes 1-6 *supra*.

212 PBW Stock Exchange v. SEC, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3610 (U.S. Apr. 11, 1974) (No. 73-1134) (court dismissed challenge to Rule 19b-2 because it was not a reviewable "order").

213 *Id.*

214 *See* text accompanying note 21 *supra*.

215 Administrative Procedure Act § 10(e), 5 U.S.C. § 706(2)(E) (1970); Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a) (1970). Under the Administrative Procedure Act "the reviewing court shall decide all relevant questions of law." 5 U.S.C. § 706 (1970).

question, whether a challenged self-regulatory action is appropriate under the Exchange Act, is a mixed question of law and fact which would probably be judged under the "substantial evidence" test.[216] The Justice Department has argued that the Commission decision would be a determination of its own authority and therefore a question of law.[217] But as a mixed question of law and fact, the Commission's authority would be kept in check by the substantial evidence test. To treat the entire issue as a question of law ignores the heavy input of factual securities issues and returns decisionmaking to de novo judicial determinations.

The Commission, on the other hand, has asserted that its quasi-legislative decisions should be judged by a standard more generous than "substantial evidence."[218] Because it relies on broad policy considerations rather than exclusively upon specific facts within the record, the SEC believes that its rules should only be invalidated where "arbitrary, capricious or an abuse of discretion, contrary to constitutional right, power, privilege, or immunity or in excess of its statutory jurisdiction or [where] the rule was adopted without observance of procedures required by law."[219] The Commission's standard is so broad that the reviewing court would almost inevitably accede to the Commission's judgment. Since the vague standards of the Exchange Act already allow considerable SEC flexibility, judicial review should invoke a greater scrutiny than the Commission's proposed standard in order to protect the rights of aggrieved parties. The "substantial evidence" test appropriately compromises the positions of both the SEC and the Antitrust Division.

4. Uniformity of Decisions

Inconsistent antitrust-securities decisions will cause considerable harm. Many areas of antitrust-securities overlap affect larger, more general securities policies. Rule 19b-2, for example, restricts

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216 *See* 3 L. Loss, *supra* note 13, at 1930-31; Note, *supra* note 177, at 103 n.24. *But see* Zuckerman v. Yount, 362 F. Supp. 858, 863 (N.D. Ill. 1973) (McLaren, J.) ("appears to present a question of fact").

217 *See* Just. Dept. Post-Trial *Thill* Brief, *supra* note 208, at 23.

218 *S. 2519 Hearings*, *supra* note 11, at 72 (testimony of Ray Garrett).

219 *Id. See* Note, *supra* note 132, at 557-59 (a reviewing court should overrule the Commission primarily when its decision appears to have been biased).

access to exchange membership as part of the effort to prepare the exchanges for the central market system.[220] Inconsistent decisions on one issue may disturb a broader security goal. Also the SEC requires flexibility for experimentation and innovation,[221] which will be discouraged if contrary decisions seem likely. Finally, changes in some securities policies require carefully supervised transitions,[222] which inconsistent decisions by antitrust courts will make all but impossible.

A concurrent jurisdiction scheme is most likely to generate decisions inconsistent between the SEC and the judiciary. "Frustration of [the] aims [of the 1934 Act] would be the inevitable consequence of duplicative or inconsistent standards announced contemporaneously by courts and Commission."[223] And inconsistent treatment and conclusions among lower courts is likely. Under a concurrent jurisdiction scheme lower courts could vary in the extent to which they defer issues to the SEC for determination, in the degree to which they accept or modify SEC determinations, and in the conclusions ultimately reached. Such inconsistencies among lower courts are also likely to lead to confusion as to permissible regulations and objectives and would result in patchwork SEC regulation rather than comprehensive, directed policies. Inconsistencies among courts have already resulted.[224] Concern regarding such disagreements among lower courts has been expressed in Congress.[225]

220 *See* BNA SEC. REG. & L. REP. (No. 185, pt. 2, Jan. 17, 1973) at 5 (statement of the SEC on Rule 19b-2).

221 *See* note 166 and accompanying text *supra.*

222 The importance of gradual and supervised transition from fixed commission rates to competitive rates is demonstrated in Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-3 to D-4 (2d Cir. June 28, 1974), *cert. granted,* 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304) (threat of bankruptcy of marginal firms with large losses suffered by the investing public).

223 Gordon v. NYSE, BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1, D-2 (2d Cir. June 28, 1974), *cert. granted,* 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304). *See* Comment, *supra* note 16, at 315.

224 The present conflict on the exemption issue for fixed minimum commission rates demonstrates the point. *See* note 49 *supra.*

225 Congressman Eckhardt (D-Tex.) stated:

> [I]t does worry me a great deal that every court which might decide a specific case would get an opportunity to determine what that court believed to constitute an interference with the purpose of the Exchange Act, and we might get a great number of divergent opinions from courts with respect to that question.

House Study Hearings, supra note 58, pt. 7, at 3758.

Reliance on Supreme Court reconciliation of lower court differences is only a partial solution. The Court would be unlikely to grant certiorari to resolve all variances among the lower courts. Whether the Supreme Court would undertake to resolve such conflicts would probably depend on the magnitude of interference with the regulatory scheme rather than whether any interference exists. Some disparities would remain. Second, temporary differences among circuits on critical issues could force fundamental changes in rules of operation for exchanges fearing further treble damage suits in the "threatening" circuit. Differences of exchange operation would make regulation more difficult.

These same divergences among the circuits, along with their unfortunate effects, are also likely under a scheme of exclusive judicial jurisdiction. Indeed such differences might be more probable in a scheme in which the SEC has no chance to speak with an adjudicatory voice.[226] An exemption scheme with judicial review might be least likely to generate inconsistencies. Because only one forum, the SEC, would have initial decisionmaking authority over antitrust-securities conflicts, a consistent pattern of resolution would be more probable.

5. Economy and Speed of Governmental Effort

Governmental efficiency should also be considered in selecting the plan of decisionmaking authority allocation.[227] Efficiency might be increased by combining policymaking and enforcement functions in one tribunal. In so doing, information obtained from the enforcers' extensive contacts with the industry can be used by those formulating policy. Enforcement would also be facilitated because the goals and intent of the policies would be clear to those who implement them.[228]

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226 Without concurrent jurisdiction authority, the SEC would be unable to decide cases that it otherwise would have considered. To the extent that such SEC determinations would have been uniform, this shift of decisions to various district courts would increase the likelihood of inconsistencies. Also the SEC would be unable, by setting a pattern of its own consistent determinations, to provide the guidance which some courts might be inclined to follow.

227 This consideration was emphasized by Prof. Louis Jaffe during a conversation at Harvard Law School, March 21, 1974.

228 Cohen, *Statement at Symposium on Current Problems in Securities Regulation*, 21 BUS. LAW. 180, 180-81 (1965).

Decisionmaking schemes requiring deliberation by both forums would cause delay. The Antitrust Division criticizes the scheme of exemption with a requirement of judicial review for this reason. If the Commission had regulatory power similar to that of the CAB and ICC it would, "if past experience with economic regulation is any guide, smother whatever innovative impulses reside in the industry under a blanket of administrative delay and complexity."[229] Delay would also result from a concurrent jurisdiction scheme. Postponement of judicial proceedings to await agency deliberation could delay final resolution. Two separate deliberations would occur where one might have been sufficient.[230]

Neither forum appears to have any substantial advantage over the other for speed in initial decisionmaking. Commission regulation might require protracted formal proceedings whenever self-regulatory organizations of the SEC wanted to act, causing expensive and time-consuming delays. Yet even those delays might not equal the time it takes to pursue an antitrust suit to the final stages of district court determination.[231]

An efficient governmental scheme would also discourage essentially state causes of action from consuming the resources of an antitrust court. Some of the antitrust actions brought against self-regulatory organizations have been primarily state contract or tort suits with antitrust complaints tacked on.[232]

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229 Antitrust Div. SEC Submission, *supra* note 115, at 3156. See notes 83-85 & 120 *supra*.

230 *Cf.* Ricci v. Chicago Mercantile Exchange, 409 U.S. 289, 309 (1973) (Marshall, J., dissenting).

231 *See, e.g.*, Thill Securities Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971), which was brought in 1969, has gone through three district court opinions, two appellate reviews, and is awaiting a fourth district court opinion, which will probably be appealed. *See also* Crimmins v. Amex, 368 F. Supp. 270 (S.D.N.Y. 1973) (second district court opinion), which (in dictum) states:

> Moreover, such suits as the one at hand [an antitrust challenge to exchange disciplinary action] requires an inordinate expenditure of time and resources for the court and the parties and, most importantly, deprive disciplinary proceedings of finality and blunt their effectiveness.

Id. at 281.

232 *See, e.g.*, Dickstein v. duPont, 443 F.2d 783 (1st Cir. 1971) (court said that this primarily state contract action should not be encouraged by antitrust courts); *cf.* Harwell v. Growth Programs, Inc., 451 F.2d 240 (5th Cir. 1971), *cert. denied*, 409 U.S. 876 (1972) (essentially an action for interference with a business relationship); Note, *supra* note 177, at 36.

Finally, consideration of governmental efficiency should also examine the forums' capabilities continually to oversee the enforcement of their decisions. Courts are limited by their reliance on the adversary process to bring deficiencies to their attention; the Commission staff can regularly determine the extent to which its orders are being carried out.[233] This facility is particularly useful when changes are being imposed on the industry gradually and continual supervision is necessary to evaluate the impact of each step.

6. Judicial Remedies and the Self-Regulatory Process

Broad district court application of the antitrust laws to the securities industry might cause such uncertainty about what self-regulatory actions are permitted that self-regulation would be seriously inhibited. When antitrust standards are unclear the exchanges must face the choice of either regulating at the risk of huge treble damage judgments or not regulating at all.[234] The basic premise of this argument — that antitrust standards are unclear — has been challenged by the congressional subcommittees studying the issue.[235] Contending that the pro-judiciary *Silver* test[236] is the accepted law, the Senate Report concluded that "the basic substantive principles for reconciling the antitrust and securities laws emerge with sufficient clarity to enable self-regulatory organizations to make rational analyses of the legality of their actions."[237]

The Senate Subcommittee's position faces two difficulties. First, the recent case of *Gordon v. NYSE*[238] adopted the pro-SEC view of *Silver*, belying the subcommittee's contention that the narrow view is clearly the applicable law. More basically, court decisions,

233 Recent Case, *Thill Securities Corp. v. NYSE*, 40 U. CIN. L. REV. 135, 141 (1971).

234 *See House Study Hearings, supra* note 58, pt. 6, at 3209 (Martin Report).

235 SENATE INDUSTRY STUDY, *supra* note 113, at 20; HOUSE INDUSTRY STUDY, *supra* note 113, at 163-64.

236 *See* Silver v. NYSE, 373 U.S. 341 (1963), and text accompanying note 6 *supra*.

237 SENATE INDUSTRY STUDY, *supra* note 113, at 20.

238 BNA SEC. REG. & L. REP. (No. 261, July 17, 1974) D-1 (2d Cir. June 28, 1974), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304). *Gordon* reflects the Second Circuit predilection for the pro-SEC view of *Silver*. *See* Stark v. NYSE, 346 F. Supp. 217, 228 (S.D.N.Y. 1972) (dictum), *aff'd per curiam*, 466 F.2d 743 (2d Cir. 1972).

which are ad hoc determinations on facts in record, do not necessarily provide a clear guide for the exchanges to follow. In *Thill Securities Corp. v. NYSE*,[239] for example, the plaintiff challenged the exchange's anti-rebate rule. Yet the Antitrust Division has approached the case as a general challenge to fixed commission rates.[240] If the eventual decision finds the anti-rebate rule to be illegal, the status of fixed commissions would be left in limbo.

The Senate Report goes on to say that even if there is some uncertainty in the area, such uncertainty is acceptable because there is no evidence of self-regulatory bodies failing to meet their statutory responsibilities from fear of antitrust liability, and because there is always some uncertainty in antitrust law.[241] Yet the threat of antitrust suits has, on occasion, forced exchanges to take self-regulatory action contrary to SEC interpretation of the Exchange Act. Threatened antitrust litigation was one reason that exchanges refused the Commission request to adopt Rule 19b-2 voluntarily.[242] Also, if an exchange decides not to discipline a member because it fears antitrust litigation, its decision is not likely to be uncovered because the SEC lacks oversight of disciplinary proceedings.[243] Treble damage possibilities magnify the risks enormously where any uncertainty exists.[244]

While it is true that some uncertainty is endemic in the antitrust field, the consequences are not as benign in the self-regulatory

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239 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

240 *See* Just. Dept. Post-Trial *Thill* Brief, *supra* note 208.

241 SENATE INDUSTRY STUDY, *supra* note 113, at 238.

242 Letter from PBW Exchange to SEC, March 2, 1972: "[I]f we took the action which you requested, our Exchange . . . would be exposed to the probability of a suit for treble damages under the antitrust laws. The cost of defense would be enormous irrespective of the outcome." *House Study Hearings, supra* note 58, pt. 7, at 3885.

243 The exchange itself is not likely to mention its decision not to discipline because it might be liable to private parties for failing to enforce its own rules. *Cf.* note 75 *supra.*

244 *See, e.g.*, Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1009 (2d Cir. 1973), *vacated and remanded*, 42 U.S.L.W. 4804 (U.S. May 28, 1974) (damages up to $120 million are sought in this class action); Thill Securities Corp. v. NYSE, 433 F.2d 264, 267 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971) ($21 million sought); letter from PBW Exchange to SEC, March 2, 1972, refusing to grant the Commission's request to adopt rule 19b-2, in *House Study Hearings, supra* note 58, pt. 7, at 3885: "If we were unsuccessful in our defense [of the antitrust suit that would result from following the SEC request] the treble damage liability could well exceed the entire resources of the Exchange."

context as in normal industrial activities. If other industries avoid all possible restraints of trade, as the uncertainty in the law encourages them to do, the public interest will suffer little. But the securities exchanges must engage in some anticompetitive conduct to fulfill their duties under the Exchange Act. If an antitrust threat causes exchanges to avoid aggressive self-regulation, the public suffers. The only possible step the Commission can now take to insure that exchanges will be free from antitrust attack is to require exchanges to adopt anticompetitive rules.[245] But this measure provides only partial protection since Commission rules would not apply retroactively to prevent suits for damages incurred prior to the issuance of the rule. Also, SEC rules under § 19(b) are limited to the twelve specific subjects mentioned in the statute, making it difficult for the Commission to immunize a disciplinary action under § 19(b).[246]

IV. Conclusions and Recommendations

A. *Optimal Solution*

The interests served by both the securities and antitrust laws should be accommodated by an authorization of a partial exemption from antitrust laws.

When an antitrust-securities controversy is raised by the SEC or by a would-be antitrust plaintiff, the SEC should be given initial decisionmaking authority over the controversy. If a contested securities practice is found by the SEC to be justified according to an anticompetitive standard added to governing SEC statutory authority, only judicial review on substantial evidence grounds would be available. If the practice is found unjustified by the SEC, then the SEC may provide available remedies to the injured parties. In addition to judicial review, a party injured by an action determined unjustified by the SEC may apply to a district

245 Antitrust liability would not attach to self-regulatory action taken pursuant to governmental order because the requisite "unlawful combination" in restraint of trade would not exist. No liability results from obeying the law. *See, e.g.*, Eastern R.R. Presidents Conf. v. Noerr Motor Freight Co., 365 U.S. 127 (1961).

246 *See* text accompanying note 21 *supra*.

court for compensatory damages. Damages would be given only if the SEC determined that the action was anticompetitive and unjustified. Treble damages would not be allowed. The judiciary would thus check SEC decisions on review and supplement SEC remedies.

1. Changes in SEC Duties and Authority

As a prerequisite to conferring initial decision jurisdiction of the SEC, Congress should alter the Commission's statutory duties and authority in order to protect the interests of persons affected by restrictive self-regulatory actions.[247] First, Commission authority over the exchanges should be increased. The Commission should be allowed to review the application of rules by exchanges such as disciplinary actions, denials of membership, or interferences with customer access to services.[248] An aggrieved person should be able to require this review.[249] The Commission also should have authority to "abrogate, alter, or supplement the rules of any self-regulatory organization" without the subject matter limitations presently in § 19(b).[250] Such review should be at the discretion of the SEC.[251] However, once the SEC undertakes such rulemaking proceedings, it should be required to provide an opportunity for written and oral presentations of data, views, or arguments.[252] The secrecy surrounding Commission relations with the self-regulatory bodies should be ended by requiring all correspondence and staff reports relating to review of rules or applications of rules of self-regulatory bodies available for public inspection or at least to the affected parties.[253]

247 The Williams Bill, *supra* note 17, § 18, provides these procedural rights, although the primary purpose of the bill is providing the SEC with adequate power for the creation of a central securities market system. The subsequent discussion largely parallels several Williams Bill recommendations, which are cited for reference. Disagreements with the Williams Bill provisions are also noted.

248 *See* Williams Bill, *supra* note 17, § 18, *amending* Securities Exchange Act of 1934 §§ 19(d)-(f).

249 *See* Williams Bill, *supra* note 17, § 18, *amending* § 19(d), which provides this right only for review of the application of the self-regulatory rules described in the text accompanying note 248 *supra*.

250 *See* Williams Bill, *supra* note 17, § 18, *amending* § 19(b). Similar authority already exists over the NASD, *see* note 38 *supra*.

251 *See* Williams Bill, *supra* note 17, § 18, *amending* § 19(b).

252 *See id.* § 18, *amending* § 19(b)(2).

253 *See id.* § 18, *amending* § 19(c)(2), which provides this right only for corre-

Specific antitrust standards should be a fundamental part of SEC regulation. Senator Williams' proposed National Securities Market System Act of 1973 (the Williams Bill)[254] would give the Commission the "responsibility to remove burdens on competition not reasonably necessary for the achievement of the purposes of this title . . . ."[255] This language adopts a compromise between the pro-SEC and pro-judiciary interpretations of *Silver*, and would protect antitrust interests without unduly circumscribing Commission discretion.[256] The exchanges and the NASD should be subject to the same anticompetitive standard and the same scope and procedures of SEC oversight.[257]

On amendments to self-regulatory organization rules, decisions on review of disciplinary proceedings, and the denial of membership or access, the SEC should be required to rule formally and to express its decision in the form of a reviewable order.[258] SEC rulings should be expressly appealable by any person adversely affected.[259] The Commission should also be forced to state reasons for its decisions, including the facts that led to its conclusions.[260] In addition, "legislative facts" (facts derived from SEC expertise and experience) should be a permissible input[261] provided that these facts are elaborated in the decision and that the parties have the opportunity to rebut such facts, when their consideration by the SEC becomes known.[262]

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spondence among the interested parties and the SEC or its staff relating to rulemaking review, not adjudicatory review.

254 *See* note 17 *supra.*

255 *Id.* § 18, *amending* §§ 19(b), 19(e)(2), & 19(f).

256 *See* text accompanying notes 181-89 *supra.*

257 *See* note 79 and accompanying text *supra.*

258 *See* Williams Bill, *supra* note 17, § 18, *amending* §§ 19(b), 19(e)(1)(A) & 19(f).

259 *See id.* § 21, *amending* § 25(b). This section would not require the plaintiff to have been a "party" to the SEC proceedings. *See* note 206 *supra.*

260 *See* Williams Bill, *supra* note 17, § 18, *amending* § 19(b)(3), which also requires an evaluation by the SEC of the principal arguments against the Commission's action.

261 The Williams Bill allows SEC consideration of ". . . such other materials as the Commission may deem material . . . ," but only for review of the applications of self-regulatory rules. *Id.* § 18, *amending* § 19(e)(1). *See also id.* § 18, *amending* § 19(f).

262 *See* Administrative Procedure Act § 7(e), 5 U.S.C. § 556 (1970), requiring an opportunity for parties to show contrary evidence where the agency takes official notice.

2. Initial Decision Jurisdiction to the Commission

The SEC should be given exclusive authority, subject to appellate review, to decide whether self-regulatory actions conflict with the anticompetitive standard of the Williams Bill.[263] Judicial review should use the "substantial evidence" standard. Since the Commission cannot provide adequate antitrust remedies for self-regulatory acts violating this standard, district courts should have jurisdiction over private antitrust suits only for the purpose of providing compensatory relief subsequent to an SEC decision that a violation has occurred.

B. *Politically Realistic Alternatives*

Congress would probably not confer so much power on the SEC in derogation of the courts' traditional antitrust role.[264] Consequently less sweeping changes in the relation between the two regulatory schemes should be sought. A scheme of concurrent jurisdiction with increased procedural safeguards and expanded review authority for the SEC might be provided,[265] and the punitive power of antitrust court remedies reduced.[266] Such modifications could be effected by passage of the Williams Bill, by making treble damage awards discretionary, and by shortening the time within which an antitrust suit can be brought.

Senator Williams' proposed amendments to the Securities Exchange Act would make the essential changes in expanding Commission review and procedural safeguards.[267] The bill's major flaw is that decisionmaking roles between the courts and the SEC are

263 *See* note 255 *supra.*

264 *See* S. REP. No. 93-865, *supra* note 79; SENATE INDUSTRY STUDY, *supra* note 113, at 233, 237; HOUSE INDUSTRY STUDY, *supra* note 113, at 161. A specific exemption from antitrust statutes might also have to pass the additional hurdle of the Senate and House Judiciary Committees, where antitrust exemptions are looked upon with even less favor. *See House Study Hearings, supra* note 58, pt. 3, at 1640, 1649.

265 *See* Williams Bill, *supra* note 17.

266 Judicial discretion in awarding damages was expressly left open by the House study. *See* HOUSE INDUSTRY STUDY, *supra* note 113, at xvii, 168. The Antitrust Division has not objected to this proposal, although they do not think the threat of huge damage awards is very real. *See S. 2519 Hearings, supra* note 11, at 201 n.4 (letter from Thomas Kauper). This suggestion might have to be passed upon by the two Judiciary Committees. *See* note 264 *supra.*

267 *See* notes 247-62 and accompanying text *supra.*

not clearly defined, but are left to the uncertainties of concurrent jurisdiction. The bill's legislative history does show a clear preference for judicial antitrust decisions.[268] A judge looking at that history might well conclude that Congress intended the courts seldom to defer to the SEC's decisionmaking by choice (primary jurisdiction), and rarely to defer by force of statute (exemption). This history even allows a court "in appropriate cases" to make a de novo determination on an issue which has been decided by the SEC and presumably upheld in judicial review under the Exchange Act.[269]

In the other direction, the wider scope of SEC review authority and added procedural safeguards provided in the bill might well persuade courts to defer more frequently to the SEC. If an adversely affected person could obtain a de novo judicial proceeding by bringing an antitrust suit, the SEC appeal process would be circumvented. Therefore a court might defer to agency decisions in order to make the appeals process meaningful.[270]

Another politically realistic suggestion would be to give judges discretion not to award treble damages against self-regulatory organizations acting within the Exchange Act.[271] The Clayton Act requires that a plaintiff recover three times his damages whenever he proves an antitrust violation.[272] Courts have enforced these treble damage provisions even when the defendant acted in good faith upon a court precedent which was overruled only in his case.[273] Even when the plaintiff is *in pari delicto* and the defendant had acted in good faith, the plaintiff can still recover treble dam-

268 *See* note 264 *supra.*

269 S. REP. No. 93-865, *supra* note 79, at 11.

270 This would be similar to the administrative law doctrine of "exhaustion of remedies." *Cf.* L. JAFFE & N. NATHANSON, *supra* note 140, at 356-59.

271 *See* note 266 *supra.*

272 Clayton Act § 3, 15 U.S.C. § 15 (1970) states: "Any person who shall be injured in his business or property by reason of anything forbidden in the anti-trust laws may sue therefor in a district court of the United States . . . and shall recover threefold the damages by him sustained, and the cost of suit, including reasonable attorney's fee."

273 The Supreme Court has been reluctant to apply a rule of law prospectively to avoid the treble damage award. *E.g.*, Simpson v. Union Oil Co., 396 U.S. 13 (1969) (per curiam) (reversed lower court decision applying the rule of law prospectively). This issue had been expressly reserved by the Court in its earlier decision on the merits, 377 U.S. 13, 24-25 (1964).

ages.[274] In the regulatory context, an agency's exercise of jurisdiction does not necessarily preclude the award of treble damages.[275] It appears that a judge has no discretion in awarding treble damages against a self-regulatory organization acting in a good faith attempt to comply with the Exchange Act.[276] The harm of treble damage awards to the self-regulatory scheme has already been noted;[277] it seems both unfair and unwise to impose these punitive measures when an exchange is attempting to fulfill its statutory obligations.[278] Furthermore, denying discretion over damages to a judge might inhibit court enforcement of the antitrust laws. The disruptive effect of these tremendous damage awards on the economy might well be a factor which a judge would consider in deciding whether it is "necessary" for the Exchange Act impliedly to repeal the antitrust laws in a given context.

Treble damages play an important role in the operation of the antitrust regulatory system by encouraging private suits.[279] In *Perma Life Mufflers, Inc. v. International Parts Corp.*[280] the Supreme Court said:

> The plaintiff who reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding policy in favor of competition. A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement.[281]

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274 Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 139 (1968).

275 *See* Apgar Travel Agency v. International Air Transport Ass'n, 107 F. Supp. 706, 711 (S.D.N.Y. 1952) (since the CAB could not award damages, the treble damage provision of the antitrust laws were applicable). *But see* Keith Ry. Equipment Co. v. Ass'n. of American R.R., 64 F. Supp. 917, 920 (N.D. Ill. 1946) (where ICC can award damages for violations of the Interstate Commerce Act there can be no treble damage award).

276 *House Study Hearings, supra* note 58, pt. 6, at 3115 (testimony of George Reycraft).

277 *See* notes 242 & 244 *supra.*

278 *See* Note, *supra* note 177, at 51: "[T]he statutory pronouncement of per se turpitude is hardly appropriate when the defendant may be attempting to execute congressional will." *Cf.* Baxter, *supra* note 5, at 692.

279 *See* HOUSE INDUSTRY STUDY, *supra* note 113, at 168.

280 392 U.S. 134 (1968).

281 *Id.* at 139.

However, making the award of treble damages discretionary in securities industry cases would not seriously impair the antitrust regulatory scheme. Injuries would still be compensated, but punitive damages would only be imposed when necessary to accomplish the purposes of the antitrust laws without endangering the viability of national securities markets. Since attorneys' fees would still be recoverable, the added burden placed on a private plaintiff would be tolerable, although his incentive to become a plaintiff would admittedly decline.

Another possibly feasible limitation on antitrust liability would restrict the time in which an antitrust action could be brought. District court jurisdiction could be available only for a specified period of time either after the self-regulatory action is taken or after SEC review and approval of the action. This limitation would prevent persistent challenges to an exchange activity which has been approved by the Commission and is subject to continuing agency review.[282]

Any attempt to improve the rather confused process by which antitrust-securities conflicts are resolved must be more than an effort to slant the scheme in favor of either antitrust or securities law values. While any change in the process of resolution will necessarily affect the substantive outcome, a sensible process will be one which minimizes the disruptive effects of uncertainty, delay, unfairness, and duplicated authority on the objectives of both antitrust and securities law. By examining those procedural considerations which can help or hinder the enforcement of both statutory schemes, this article hopes to point out the importance of those factors in the fashioning of an effective process for antitrust-securities conflict resolution.

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282 *Cf.* a similar provision for bank merger approvals, Bank Merger Act of 1966, 12 U.S.C. § 1828 (1970).

NOTE

EPA REGULATION OF "INDIRECT SOURCES": A SKEPTICAL VIEW

Introduction

On June 11, 1974, the House of Representatives failed to pass[1] the National Land Use Policy Act.[2] Most observers interpreted this event as a serious setback to the development of federal land use controls, at least for the immediate future.[3] Yet in July, 1975, the Environmental Protection Agency (EPA) will begin to implement regulations under the Clean Air Act as amended in 1970,[4] which provide for even more extensive federal controls than those contained in the National Land Use Policy Act.[5] Pursuant to those regulations,[6] EPA intends to review the construction of "indirect sources of air pollution" — those facilities which "do not themselves emit pollutants, but which attract increased motor vehicle activity and thereby may . . . prevent or interfere with the attainment or maintenance of an ambient air[7] quality standard."[8] Taken on its face, this definition asserts EPA authority to review virtually all new commercial, residential, and industrial construction, since any new development can be expected to "attract increased motor vehicle activity" which "may . . . prevent or interfere with the attainment or maintenance of an ambient air quality standard."[9]

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1 120 CONG. REC. H5019-42 (daily ed. June 11, 1974).

2 H.R. 10294, 93d Cong., 2d Sess. (1974).

3 *See* Noone, *Environment Report/House Deals Fatal Blow to 1974 Land Use Legislation*, 6 NAT'L J. REP. 928-29 (1974).

4 42 U.S.C. § 1857 (1970), *amending* 42 U.S.C. § 1857 (1964).

5 The proposed National Land Use Policy Act provided for $800 million in federal grants to help states develop comprehensive land use plans. There was no provision for direct federal regulation of land use decisions. The grant mechanism was the only source of federal inducement. H.R. 10294, 93d Cong., 2d Sess. (1974).

6 39 Fed. Reg. 7270 (1974).

7 "Ambient air" is "that portion of the atmosphere, external to buildings, to which the general public has access." 40 C.F.R. § 50.1(e) (1973).

8 39 Fed. Reg. 7270 (1974).

9 The regulations provide that "indirect sources include, but are not limited to" the following eight classes of sources: (1) highways and roads; (2) parking fa-

This Note will first examine whether EPA has been granted statutory authority for the regulation of indirect sources. The second portion of the analysis will explore the legal and technical difficulties involved in the implementation of the indirect source regulations.

I. Legal Authority for the Regulation of Indirect Sources

Serious questions have been raised regarding EPA's authority to regulate "indirect sources" of air pollution.[10] The term "indirect source" appears in neither the Clean Air Act,[11] nor the Senate or House reports for the 1970 amendments.[12] As a result, it has been argued that the 1970 amendments were never intended to reach such "sources."[13] According to this view, EPA's authority is limited to the regulation of direct sources of air pollution — those stationary and mobile sources which emit pollutants themselves.[14] Prior to examining the statutory grant of authority to EPA, it is necessary to ascertain the extent of EPA's claimed authority by determining the origin of the term "indirect source."

A. *Development of the Indirect Source Concept*

The Clean Air Amendments of 1970[15] were designed to accelerate both federal and state efforts to clean up the nation's

cilities; (3) retail, commercial and industrial facilities; (4) recreation, amusement, sports and entertainment facilities; (5) airports; (6) office and government buildings; (7) apartment and condominium buildings; and (8) education facilities. *Id.* at 7276. The rationale for the selection of these eight classes and the exclusion of others will be examined in section II *infra*.

10 *See* Comments submitted by the International Council of Shopping Centers on the proposed regulations, pt. III, at 4-18 (Nov. 28, 1973) [hereinafter cited as I.C.S.C. Comments] (on file at EPA Headquarters in Washington, D.C.).

11 The only terms used are "stationary source," "existing source," and "new source." By definition, both "existing sources" and "new sources" are "stationary sources." A "stationary source" is "any building, structure, facility, or installation which emits or may emit any air pollutant." 42 U.S.C. § 1857c-6 (1970).

12 *See* H.R. Rep. No. 1146, 91st Cong., 2d Sess. (1970) and S. Rep. No. 1196, 91st Cong., 2d Sess. (1970).

13 *See* I.C.S.C. Comments, *supra* note 10.

14 *Id.*

15 Pub. L. No. 91-604, 84 Stat. 1676, *amending* 42 U.S.C. § 1857 (1964) (codified at 42 U.S.C. § 1857 (1970)).

air. The amendments required that national ambient air quality standards be established for all major air pollutants.[16] Two sets of standards were required for each pollutant: a primary standard requisite to protect the public health,[17] and a secondary standard requisite to protect the public welfare.[18] Each state was required to develop an implementation plan which would insure achievement of the primary standards "as expeditiously as practicable but . . . in no case later than three years" from the date the plan received federal approval.[19] The more restrictive secondary standards were to be attained within "a reasonable time."[20] Once the standards had been achieved, the plans were required to provide measures for their maintenance.[21] Unfortunately, neither the Act nor the Implementation Plan Development Regulations[22] spelled out precisely how the standards were to be maintained.[23]

On May 31, 1972, the Administrator of the Environmental Protection Agency published his initial set of approvals and disapprovals of state implementation plans.[24] Shortly thereafter, the Natural Resources Defense Council (NRDC) and Friends of the Earth, two national environmental organizations, filed suit[25]

16 *See* H.R. REP. No. 1783, 91st Cong., 2d Sess. 44 (1970).
17 42 U.S.C. § 1857c-4(b)(1) (1970).
18 *Id.* § 1857c-4(b)(2).
19 *Id.* § 1857c-5(a)(2)(A)(i).
20 *Id.* § 1857c-5(a)(2)(A)(ii).
21 *Id.* § 1857c-5(a)(2)(B).
22 40 C.F.R. pt. 51 (1973).
23 The Act specifies only that each plan, to be approvable, must include "emission limitations, schedules, and timetables for compliance with such limitations, and such other measures as may be necessary to insure attainment and maintenance of such primary or secondary standard, including, but not limited to, land use and transportation controls." 42 U.S.C. § 1857c-5(a)(2)(B) (1970).
Section 51.12(a) of the Implementation Plan Development Regulations provides only that:

> In any region where existing (measured or estimated) ambient levels of pollutant exceed the levels specified by an applicable national standard, the plan shall set forth a control strategy which shall provide for the degree of emission reduction necessary for attainment and maintenance of such national standard, including the degree of emission reduction necessary to offset emission increases that can reasonably be expected to result from projected growth of population, industrial activity, motor vehicle traffic, or other factors that may cause or contribute to increase [*sic*] emissions.

40 C.F.R. § 51.12(a) (1973).
24 37 Fed. Reg. 10842-906 (1972).
25 NRDC v. EPA, 475 F.2d 968 (D.C. Cir. 1973).

against the Administrator of EPA for failing to require the inclusion of transportation controls[26] in the state plans. The suit also charged that the state plans as approved by the Administrator were inadequate to insure maintenance of the air quality standards. Regarding the latter allegation, the United States Court of Appeals for the District of Columbia Circuit determined that:

> In view of the competing contentions with respect to whether or not each state plan approved by the Administrator provided for maintenance of the primary and secondary standards beyond the May 31, 1975 attainment date, and in view of the absence of any definite indication in the present record as to whether or not such a state-by-state determination was made, the Administrator shall, within 30 days from the date of this order, review the maintenance provisions of all state implementation plans presently approved. Those plans which do not provide for measures necessary to insure the maintenance of the primary standard after May 31, 1975, and those plans which do not analyze the problem of maintenance of standards in a manner consistent with applicable regulations . . . shall be disapproved.[27]

Pursuant to the court-ordered review, the Administrator found that none of the state plans which had been approved prior to the court order provided adequate procedures for the maintenance of the national standards.[28] In the Administrator's judgment, the maintenance requirement could only be satisfied if the state plans contained "procedures by which each State will review a wide range of new sources and causes of air pollution and will have the authority to prevent the development of such sources or causes where necessary to insure that the standards are maintained."[29]

The Administrator further indicated that some of the procedures for insuring maintenance were already required by the Im-

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26 Transportation controls are restrictions imposed on the use of motor vehicles in order to reduce the number of vehicle miles traveled in a heavily polluted metropolitan area. They include such measures as parking restrictions and surcharges, exclusive bus lanes, inspection programs, and gasoline sales limitations. *See* 40 C.F.R. § 51.1(r) (1973).

27 475 F.2d at 971-72.

28 38 Fed. Reg. 6279 (1973).

29 *Id.*

plementation Plan Development Regulations. For example, each state plan was required to have adequate procedures for the review of the construction of any stationary source "at a location where emissions from that source would result in interference with the attainment or maintenance of a national standard or with the State control strategy."[30] New source performance standards[31] and the Federal Motor Vehicle Control Program[32] were also cited by the Administrator as measures which would assist the states in insuring maintenance of the standards.

The Administrator found, however, that "these measures, by themselves, are not adequate to insure the maintenance of standards, particularly for air pollutants emitted largely by motor vehicles."[33] The basis for the Administrator's decision was not disclosed. Presumably, he determined that the rate at which new cars containing the 1975 emission control devices would be introduced into the vehicle population would be inadequate to insure maintenance of the standards.[34] Projected growth in the number of automobiles and skepticism that the 1975 emission control devices would perform to specifications may also have contributed to the finding.[35]

To remedy the expected shortfall, the Administrator determined that:

> [I]t is also necessary to require States to review, and where necessary prevent, the construction of facilities which may re-

30 *Id.*

31 These are standards for emission limitations for new stationary sources of air pollution. They are designed to require "the best system of emission reduction which (taking into account the cost of achieving such reduction) the Administrator determines has been adequately demonstrated." 42 U.S.C. § 1857c-6(a)(1) (1970).

32 The Federal Motor Vehicle Control Program required a 90% reduction from 1970 levels in the emission of hydrocarbons and carbon monoxide by light duty vehicles manufactured in mid-1975, and a 90% reduction from 1971 levels in the emissions of nitrogen oxides by light duty vehicles manufactured in mid-1976. The compliance dates were postponed to 1977 and 1978 respectively in the Energy Supply and Environmental Coordination Act of 1974, § 5(a)-(b), 42 U.S.C.A. § 1857f-1 (b)(1) (Supp. Sept. 1974), *amending* 42 U.S.C. § 1857f-1(b)(1) (1970).

33 38 Fed. Reg. 6279 (1973).

34 This was one reason given by the Administrator for requiring the imposition of transportation controls in many areas where additional emission reductions would be necessary to achieve the primary standards by 1975. The same reasoning would presumably apply to maintenance of the standards. *Id.* at 16554.

35 *See* D. WEEDEN, MANHATTAN AUTO STUDY I-19 to I-20 (1972) [hereinafter cited as MANHATTAN AUTO STUDY] (on file with *Harvard Journal on Legislation*).

> sult in increased emissions from motor vehicle activity or emissions from stationary sources that could cause or contribute to violations of national ambient air quality standards. Such facilities generally are designated "complex sources."[36]

Thus, the "complex" or "indirect source" concept was born. The origin of the concept was not disclosed, nor was any support provided for the statement that "such facilities generally are designated 'complex sources.' "[37] The Administrator conceded that "EPA guidelines[38] did not require [indirect source regulation] and the review of State plans indicates that no State included such a provision in its implementation plan."[39] This statement suggests that the concept of regulating indirect sources was indeed novel and the characterization by the Administrator of complex sources as having been "generally . . . designated" does not rebut the fact that EPA was asserting a heretofore unclaimed power.

However, the Administrator suggested that the court order in *NRDC* required regulation of such sources: "[I]n order to comply with the court order, it has been determined that all State plans must be disapproved to the extent that they do not contain provisions which will permit the review, and provide the authority to prevent, the construction, modification, or operation of complex sources . . . . "[40] In fact, the court never required, or even suggested, the regulation of complex sources. The only issue decided by the court was the *adequacy* of the state plans to insure maintennace of the standards.[41]

EPA's evaluation of the maintenance provisions in the state implementation plans,[42] issued on March 8, 1973, was designated

36 38 Fed. Reg. 6279 (1973).

37 *Id.*

38 This presumably refers to the Implementation Plan Development Regulations, 40 C.F.R. pt. 51 (1973).

39 38 Fed. Reg. 6279 (1973).

40 *Id.*

41 The court directed the Administrator to disapprove "those plans which do not provide for measures necessary to insure the maintenance of the primary standard after May 31, 1975, and those plans which do not analyze the problem of maintenance of standards in a manner consistent with applicable regulations, *see* 40 C.F.R. § 51.12(a) . . . ." 475 F.2d at 972. See note 23 *supra* for text of 40 C.F.R. § 51.12(a).

42 38 Fed. Reg. 6279 (1973).

by the Administrator as "an advance notice of proposed rulemaking" that would amend the original set of Implementation Plan Development Regulations.[43] On April 18, 1973, the Administrator issued a formal "notice of proposed rulemaking" in which he proposed specific amendments to the regulations.[44] These amendments did not contain actual review procedures, nor did they specify which indirect sources would be subject to review; rather, they required that each state develop its own review procedures and submit them for the Administrator's approval by August 15, 1973.[45] Final regulations requiring the submission of indirect source review proposals were published on June 18, 1973.[46] In response to several comments on the proposed regulations, the Administrator added an additional requirement that the states submit a comprehensive growth analysis identifying those areas which "may have the potential for exceeding any national standard within the subsequent 10-year period."[47] This additional requirement was imposed because "preconstruction review of individual sources could not adequately deal with generalized growth and its impact on regional air quality."[48] To the Administrator, therefore, indirect source review, "while 'a necessary addition' to an overall strategy for assuring maintenance, could be considered only an additional tactic in such strategy."[49] Compliance with the "growth analysis" requirement was deferred until June 18, 1974.[50]

The response to the Administrator's request that state proposals provide for review of indirect sources was disappointing. While the court in *NRDC* imposed an August 15, 1973 deadline,[51] by October 30, 1973, only seven states or territories had

43 *Id.* at 9599.
44 *Id.*
45 *Id.* at 9600.
46 *Id.* at 15834.
47 Comprehensive growth plans are designed to deal with the aggregate of pollutants generated by all sources, not only those covered by the indirect source regulations. *Id.*
48 *Id.*
49 39 Fed. Reg. 7270 (1974), *quoting* 38 Fed. Reg. 15834 (1973).
50 39 Fed. Reg. 7270 (1974).
51 475 F.2d at 972. The April 15 deadline was changed to August 15 in a modification of the order issued on February 12, 1973. 38 Fed. Reg. 9600 (1973). But note that the *NRDC* opinion did not directly face the question of indirect source

submitted review procedures.[52] Of these, only three[53] had satisfied EPA's requirements. Consequently, the Administrator was forced to propose mandatory federal review procedures for those states which had failed to submit approvable plans.[54] On October 30, 1973, EPA proposed a set of regulations requiring preconstruction review of a broad range of indirect sources.[55] In the notice accompanying the proposed regulations, the Administrator emphasized that such review should be carried out at the state or local level since essentially local land use questions were involved, but warned that EPA was prepared to enforce the regulations itself if the states failed to do so.[56]

The "final" federal indirect source review procedures were promulgated on February 25, 1974.[57] In a somewhat unusual move, the Administrator announced in the preamble to the February regulations that additional comments would be accepted until April 1, 1974, and that "where appropriate," additional changes would be made.[58] On July 9, 1974, the Administrator promulgated a series of amendments to the February 25th regulations.[59]

By February 14, 1974, technically the last date by which a state could substitute its own review procedures for the federally mandated ones, only seven additional states had submitted their own plans.[60] Of the fourteen plans, only two, those submitted by Florida and Guam, had received final approval.[61] In consequence EPA has now committed itself to imposing indirect source controls in the great majority of states.[62]

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review; it merely required the submission by the deadline of state plans for achieving and maintaining the primary ambient air quality standards. *See* note 41 *supra*.

52 The seven states and territories were Alabama, Florida, Puerto Rico, Guam, Maine, New York and Oregon. 38 Fed. Reg. 29893 (1973).

53 The three were Alabama, Florida and Guam. *Id.* at 29893-94.

54 This was required by the court order in *NRDC*, 475 F.2d at 971.

55 38 Fed. Reg. 29893-96 (1973).

56 *Id.* at 29894.

57 39 Fed. Reg. 7270 (1974).

58 *Id.* at 7276.

59 *Id.* at 25292-301.

60 *Id.* at 7271.

61 *Id.*

62 While EPA is prepared to make such decisions, it is still trying to get the states to set up the necessary review mechanism. *Id.*

B. *Statutory Authority*

Before examining the legislative history of the Act to determine if indirect source review authority exists, it is necessary to determine the authority EPA claims over indirect sources. The regulations require that each state have the legal authority to "[p]revent construction, modification, or operation of a facility, building, structure, or installation, or combination thereof, which directly or indirectly results or may result in emissions of any air pollutant at any location which will prevent the attainment or maintenance of a national standard."[63] Inherent in that authority are the following elements: (1) authority to prevent construction based on a review of projected emissions from or associated with the facility; (2) authority to require modifications in the size or design of a proposed facility prior to approval or in the operation of the facility after construction; and (3) authority to prevent the construction of a facility based on emissions not emitted by the facility itself, but by motor vehicle traffic generated by the facility.

1. Explicit Statutory Authority

Preconstruction review of only one class of sources is specifically authorized by the Act. Each implementation plan must include "a procedure, meeting the requirements of [42 U.S.C. § 1857c-5(a)(4) (1970)], for review (prior to construction or modification) of the location of new sources to which a standard of performance will apply."[64] "Standard of performance" is a term of art which is defined in § 1857c-6(a)(1).[65] It applies only to new stationary sources. A "stationary source" is defined in § 1857c-6(a)(3) as "any building, structure, facility, or installation which emits or may

63 40 C.F.R. § 51.11(a)(4) (1973).

64 42 U.S.C. § 1857c-5(a)(2)(D) (1970).

65 "Standard of performance" is "a standard for emissions of air pollutants which reflects the degree of emission limitation achievable through the application of the best system of emission reduction which (taking into account the cost of achieving such reduction) the Administrator determines has been adequately demonstrated." *Id.* § 1857c-6(a)(1).

emit any air pollutant." While the Act does not define the word "emit," it is quite clear from the list of examples[66] provided in the Senate Report that a stationary source is one which *itself* emits pollutants as a part of some combustion or other industrial process. Further support for this interpretation is provided by the Senate Report's emphasis on available "control technology."[67] Such technology could only be applied to reduce emissions coming from the stationary source itself.[68]

Citizens Ass'n v. Washington[69] provides additional support for the view that the Act, in authorizing preconstruction review of stationary sources, does not reach indirect sources. The court rejected plaintiff's contention that a permit was required for the construction of a new parking garage under regulations adopted by the District of Columbia pursuant to 42 U.S.C. § 1857c-5. The court held that "[s]ince Defendants' parking garages are alleged to contain mobile sources of emissions, the present stationary source regulations concerning direct emissions from the building itself are inapplicable."[70]

The same conclusion was reached by the court in *Metropolitan Washington Coalition for Clean Air v. Department of Economic Development.*[71] Here the court interpreted a regulation containing a definition of a stationary source identical to that used in the Clean Air Act[72] itself:

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66 Among the sources listed in the Senate Report are: cement manufacturing, coal cleaning operations, ferro-alloy plants, gray iron foundries, nitric acid manufacturing, petroleum refining, steam electric powerplants, and sulfuric acid manufacturing. All of these and the other sources listed emit pollutants directly as a result of some industrial or combustion process. S. REP. No. 1196, 91st Cong., 2d Sess. 16 (1970).

67 For example, the Senate Report states that "[t]he performance standards should be met through application of the latest available emission control technology or through other means of preventing or controlling air pollution." *Id.*

68 There is no technology which the owner of an indirect source could apply to reduce emissions associated with the source. Emission control devices on new automobiles are required as part of the Federal Motor Vehicle Control Program; owners of an indirect source, however, are not responsible for the enforcement of this requirement and could not be prosecuted if the automobiles which are attracted to the indirect source fail to have such devices.

69 370 F. Supp. 1101 (D.D.C. 1974).

70 *Id.* at 1109.

71 373 F. Supp. 1096 (D.D.C. 1973).

72 42 U.S.C. § 1857c-6(a)(3) (1970).

> While the Court agrees with Plaintiff that the D.C. regulations, particularly Section 8-720(g) require a determination by the Commissioner that the operation of the proposed garage will not prevent or interfere with the attainment or maintenance of any applicable local or national ambient air quality standard, the Court respectfully does not believe that the Commissioner must incorporate a consideration of the proposed garage's indirect effects on air quality into the generally accepted interpretation of "stationary sources," that is, "facilities that affect or may affect air quality because of their own pollutant emissions." Since automobiles are not fixtures of the proposed building, their projected emissions within the building do not appear from the District's interpretation of "stationary source" to be a factor in the computation necessary to determine whether the proposed parking facility is exempt from the stationary source provisions under Section 8-2:720(j).[73]

Thus, it appears that § 1857c-6 cannot presently be stretched beyond the stationary source language to include review of "indirect sources" of air pollution.[74]

2. Implied Statutory Authority

While the term "indirect source" appears nowhere in the Clean Air Act,[75] the Administrator has argued[76] that the following provision provides the necessary legal authority: "The Administrator shall approve such plan . . . if he determines that . . . it includes emission limitations, . . . and such other measures as may be necessary to insure attainment and maintenance of such primary or secondary standard, including, but not limited to, land-use and transportation controls."[77] Although EPA has focused on this language,[78] the Agency has not indicated whether

73 373 F. Supp. at 1099 (footnote omitted).

74 That the Administrator has not chosen to justify indirect source review under the provisions covering new stationary source review is evidence that EPA shares this interpretation.

75 *See* note 11 *supra*.

76 39 Fed. Reg. 7273 (1974).

77 42 U.S.C. § 1857c-5(a)(2)(B) (1970).

78 39 Fed. Reg. 7273 (1974), *quoting* 42 U.S.C. § 1857c-5(a)(2)(B) (1970).

it deems indirect source review a "transportation control," "land use control," or some "other measure."

a. Land Use and Transportation Controls

Ignoring for a moment the possibility that such review is authorized by the "other measures" language in § 1857c-5(a)(2)(B),[79] it follows that authority for review of indirect sources must come, if at all, from the provision for "land use and transportation controls."[80] It is here that the legislative history of the Act becomes helpful in determining whether indirect source review is authorized.

The 1970 House bill[81] made no provision for either land use or transportation controls. It required only that "the state plan assures achieving such standard of air quality within a reasonable time."[82] The Senate bill,[83] on the other hand, contained a lengthy provision for such controls:

> The Secretary shall approve [a state implementation plan] . . . if he determines that it . . . (D) includes, to the extent necessary, appropriate procedures, including, but not limited to, land-use and air and surface transportation controls and permits, for insuring that any source of air pollution agents or combination of such agents will be located, operated, and for other than moving sources, designed, constructed, and equipped in such a way that such sources will not interfere with implementation, maintenance, and enforcement of any applicable air quality standard and goal.[84]

While this provision appears very broad on its face, language in the Senate Report suggests that the proposed land use controls were to be applied only to *stationary* sources, while the transportation controls were reserved for *moving* sources:

> In addition to direct emission controls, other potential parts of an implementation plan include land use and air and surface transportation controls. These should insure that

79 See text accompanying notes 102-14 *infra* for a brief discussion of this possibility.

80 42 U.S.C. § 1857c-5(a)(2)(B) (1970).

81 H.R. 17255, 91st Cong., 2d Sess. (1970).

82 *Id.* § 4(a).

83 S. 4358, 91st Cong., 2d Sess. (1970).

84 *Id.* § 6, which was intended to add § 111(a)(2)(D) to the Clean Air Act.

> any existing or future stationary source of air pollution will be located, designed, constructed, equipped, and operated, and that moving sources will be located and operated so as not to interfere with the implementation, maintenance, and enforcement of any applicable air quality standard or goal.
>
> The Committee acknowledges that this would require each region to make difficult judgments about the siting of facilities which may emit pollution agents, including decisions to prohibit the location of new sources which, although in compliance with Section 113, would contribute to a violation of a regional air quality standard. These factors would necessitate long-term decisions about the character of the growth and development of such region.[85]

Section 6 of the Senate bill, which was intended to add § 113 to the Clean Air Act, provided for certification of compliance with new source performance standards. Its provisions are comparable to those contained in 42 U.S.C. § 1857c-6.[86] "[N]ew sources . . . in compliance with § 113" are necessarily stationary sources.[87] And if, as seems apparent in the context of the Senate Report, the Senate bill's "land use . . . controls" apply to stationary sources only, they would not reach indirect sources of air pollution.[88]

The conference bill split the Senate provision into two parts. The provision for "land use and air and surface transportation controls and permits" was reduced to "land use and transportation controls." The new phrase was added to the "other measures" in § 1857c-5 which "may be necessary to insure attainment and maintenance of such primary or secondary standard." Problems of interpretation have developed because the modified phrase was lifted out of its original context. The original Senate bill made it clear that "land use controls" were to be the means for insuring

85 S. REP. No. 1196, 91st Cong., 2d Sess. 12-13 (1970).

86 Both provisions required new stationary sources to meet a "standard of performance" which "reflects the degree of emission limitation achievable through the application of the best system of emission reduction which (taking into account the cost of achieving such reduction) the Administrator determines has been adequately demonstrated." 42 U.S.C. § 1857c-6(a)(1) (1970).

87 "New source" is defined in § 113 as "any stationary source, the construction or modification of which is begun on or after the effective date of any standard of performance established under this section applicable to such source . . . ." S. 4358, 91st Cong., 2d Sess. § 6 (1970), which was intended to add § 113(a)(2) to the Clean Air Act.

88 *See* text accompanying notes 65-68 *supra* for the analysis which concludes that indirect sources are excluded from the statutory meaning of "stationary sources."

that stationary sources[89] did not "interfere with implementation, maintenance, and enforcement of any applicable air quality standard and goal."[90] The Conferees created a separate provision for preconstruction review of stationary sources without including the term "land use controls."[91] The provision provides for precisely the same type of review which the original "land use controls" language did in the Senate bill. It is suggested that, absent other evidence, the Conferees' shift of the phrase "land use controls" to the "other measures" section added nothing to its original, Senate bill meaning.

The evidence which does exist supports this interpretation. The Conference Report did not indicate that the "land use control" concept was expanded to include indirect source review, or any other form of review beyond the location of new stationary sources. The Report merely states that "[u]nder the Senate bill [an] implementation plan would also have to provide for necessary land-use and transportation controls, intergovernmental cooperation to attain standards and goals, . . . and certain other requirements."[92] Without any further discussion, the Report concludes that "[t]he conference substitute follows the Senate amendment in establishing deadlines for implementing primary ambient air quality standards but leaves the States free to establish a reasonable time period within which secondary ambient air quality standards will be implemented."[93]

The legislative history of "transportation controls" also lacks specific reference to the question of indirect source regulation. The Senate Report, as noted earlier,[94] seems to limit the scope of transportation controls to "moving sources." While the Act lacks a definition of moving source, it seems apparent that such a source must "move" — in contrast to indirect sources, which are fixed-site facilities attracting moving sources. At least in the Senate, therefore, regulation of indirect sources under the "transportation controls" power appears not to have been intended.

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89 *See* text accompanying note 85 *supra.*

90 S. 4358, 91st Cong., 2d Sess. § 6 (1970), which was intended to add § 111(a)(2)(D) to the Clean Air Act.

91 For the language of this provision see text accompanying note 64 *supra.*

92 H.R. REP. No. 1783, 91st Cong., 2d Sess. 45 (1970).

93 *Id.*

94 See text accompanying notes 84-85 *supra.*

The Senate Report does suggest some of the types of transportation control measures which Congress had in mind:

> The Committee recognizes that during the next several years, the attainment of required ambient air quality in many of the metropolitan regions of this country will be impossible if the control of pollution from moving sources depends solely on emission controls. The Committee does not intend that these areas be exempt from meeting the standards. Some regions may have to establish new transportation programs and systems combined with traffic control regulations and restrictions in order to achieve ambient air quality standards for pollution agents associated with moving sources.[95]

This language does not immediately suggest that authority to regulate indirect sources. Unfortunately, the Conference Report provides no additional guidance.

The only other source of legislative history on the subject is a series of statements made by Senator Muskie on the floor of the Senate during the debate prior to adoption of the Conference Committee bill. His statements appear to expand substantially the transportation control concept:

> If the [state implementation] plan is approved, Congress expects the federal regulatory agencies to take the steps necessary to assure compliance with the plan; because what is involved in these greater urban areas, from the standpoint of air pollution, is the whole complex of residential patterns, employment patterns, and transportation patterns — the way in which people move about, go to their work and live — and all of this ought to be subject to *modifications*, and must be modified if the objective of clean air is to be achieved.[96]

Certainly, modifications in the way people "work and live" would seem to include the authority to limit the size or parking capacity of both residential and commercial facilities. Whether the House would have agreed with this broad definition of valid transportation control measures, however, is problematical. There is no reference to transportation controls in any of the House debates, either on the original House bill (which contained no provision for such controls), or on the Conference bill.

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95 S. REP. No. 1196, 91st Cong. 2d Sess. 13 (1970).
96 116 CONG. REC. 42393 (1970) (emphasis added).

Despite this rather inconclusive legislative history, the Administrator has asserted authority to limit the size of parking garages and to impose other parking restrictions in the regulations promulgated to assist states in the development of transportation control plans.[97] Congress's response suggests that, whatever its intent in 1970, it presently feels that EPA may have pushed the transportation control concept too far. The Energy Supply and Environmental Coordination Act of 1974[98] directed EPA to suspend all surcharges on commuter parking[99] until a more thorough study of their impact had been made.[100] This Act also required the Administrator to delay the effective date of the indirect source and other parking management regulations[101] until January 1, 1975.[102]

b. Other Measures

The meaning intended by Congress for the "other measures" language of the statute is even more obscure than that of the

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97 38 Fed. Reg. 16552 (1973).

98 Pub. L. No. 93-319, 88 Stat. 246 (1974).

99 A surcharge on commuter parking is an additional fee which is added to the regular commercial rate in order to discourage commuting by private auto into the central cities, and thereby reduce air pollution. EPA had included this provision in a number of transportation control plans. 39 Fed. Reg. 1848 (1974).

100 Energy Supply and Environmental Coordination Act of 1974, § 4(b), 42 U.S.C.A. § 1857c-5(c)(2) (Supp. Sept. 1974).

101 The postponement in the application of the indirect source regulations can be interpreted as signifying implied congressional approval of EPA's authority to regulate indirect sources. *See* South Terminal Corp. v. EPA, Civil No. 73-1366 (1st Cir. Sept. 27, 1974) at 34-35. However, the House Report does not support this interpretation. It states that "the committee does not intend to question either the need for, *or the authority of the Administrator to impose,* transportation control plans." H.R. REP. No. 1013, 93d Cong., 2d Sess. 24 (1974) (emphasis added). But Congress delayed the application of the regulations to provide itself with an opportunity to scrutinize transportation controls. *Id.* at 23-24. Indeed, recent congressional action has forced EPA to postpone the effective date of the regulations from January 1 to July 1, 1975. 39 Fed. Reg. 45014 (1974). This action consisted of a rider to the EPA appropriation bill which prohibited the expenditure of any funds for the implementation of the regulations during fiscal 1975. Pub. L. No. 93-563, 88 Stat. 1822 (Dec. 31, 1974).

The "other" parking management provisions to which the Act refers are presumably those included in several of the transportation control plans which required review of new parking facilities with 250 or more spaces. *See* 39 Fed. Reg. 1848 (1974).

102 42 U.S.C.A. § 1857c-5(c)(2)(C) (Supp. Sept. 1974).

"land use and transportation controls" language discussed above. Yet the inference is strong that Congress, in specifying land use and transportation controls, intended those examples to be representative of the "other measures" to be employed. To the extent, therefore, that the legislative history analyzed above casts EPA's claim in doubt, it fails also to generate a source of authority based upon the "other measures" language.

In the absence of strong evidence either way, a finding of congressional intent to authorize indirect source review may turn upon the courts' view of the accuracy with which projected emissions can be calculated. The courts would be unwilling to find authority if that required ascribing to Congress an awkward and perhaps unworkable regulatory scheme. While Congress did specifically authorize preconstruction review of stationary sources based on their projected emissions,[103] the problems involved in preconstruction review of indirect sources are considerably more complex. The quantity of pollutants "generated" by an indirect source depends not only on the number of automobiles attracted to the source, but also on average vehicle speed, emission characteristics, wind conditions, and a host of other variables,[104] over which the operator has little or no control.[105] Emissions from a stationary source, on the other hand, will depend largely on the type of control technology adopted,[106] or the characteristics of the fuel used in a combustion process.[107] In either case, reasonably accurate emission forecasts can be developed prior to construc-

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103 *See* text accompanying notes 64-66 *supra.*

104 For a discussion of the impact of each of these factors, *see* NEW YORK STATE DEP'T OF ENVIRONMENTAL CONSERVATION, NEW YORK CITY METROPOLITAN AREA AIR QUALITY IMPLEMENTATION PLAN TRANSPORTATION CONTROLS 2-2 (Apr. 1973) [hereinafter cited as NEW YORK PLAN].

105 The owner cannot influence, for example, the level of "other" traffic which uses the streets surrounding his facility. He cannot order the city to widen highways to reduce congestion or provide more police to facilitate traffic flow. The only real option available to an owner or operator is to close down his facility or restrict entrance to it.

106 The manufacturers of emission control technology usually certify the removal efficiency of their equipment, thus enabling accurate predictions of the quantity and character of actual emissions. *See, e.g.,* 40 C.F.R. pt. 51, app. B, para. 3.1 (1973).

107 The sulfur content of oil or coal, for example, will largely determine the quantity of sulfur dioxide emissions. Formulas have been derived which permit quite accurate estimates of emissions based on sulfur content. *Id.*

tion.[108] This is not necessarily the case with emissions generated by an indirect source.[109]

Wuillamey v. Werblin,[110] which arose prior to the promulgation of the indirect source regulations, involved the construction of a proposed sports facility.[111] Plaintiffs alleged that construction of the complex would interfere with the attainment and maintenance of the national standards in 1975. In denying plaintiff's request for a preliminary injunction, the court stated: "An estimate of possible air pollution generated by use of the Complex in 1975 (its scheduled completion date) is, at best, highly speculative. Such speculation seems entirely to foreclose the plaintiffs' ability to demonstrate that, absent an injunction, they will suffer any harm, 'irreparable' or other."[112]

The court in *Citizens Ass'n v. Washington*,[113] citing the *Wuillamey* decision, noted that "estimating the increased air pollution generated from defendants' projects is a highly speculative undertaking, . . . and may very well present judicially unmanageable standards."[114] As these cases indicate, if indirect source review is to be construed as one of the "other measures" used to achieve and maintain the ambient air quality standards,

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108 Such forecasts are routinely used by EPA in its advisory preconstruction review of the air quality impact of new stationary sources subject to the new source performance standards. *See, e.g.*, 39 Fed. Reg. 20792 (1974).

109 An engineer at EPA has conceded that "this method [traffic flow characteristic guidelines] for estimating concentrations has not as yet been validated in the vicinity of a complex source." The same intra-Agency memorandum cautions that "[i]t seems more likely that concentrations are more greatly influenced by sources very close to the receptor [person] than is suggested by the estimation technique used herein." Unpublished EPA Memorandum to the Files from Edwin L. Meyer, Jr., Engineer, Model Application Section, Source Receptor Analysis Branch 4 (Apr. 3, 1973) (on file with *Harvard Journal on Legislation*). But the Memorandum predates several major studies concerning indirect sources by EPA. More appropriate guidelines have been developed and will be available in early 1975. Letter from Edwin L. Meyer, Jr., to Robert Rauch, Nov. 1, 1974 (on file with *Harvard Journal on Legislation*).

110 364 F. Supp. 237 (D.N.J. 1973).

111 The facility involved in this case would certainly have been subject to review under the indirect source regulations as published in 39 Fed. Reg. 7270 (1974). As the court indicated, "[t]he stadium alone is to have a capacity of around 75,000 persons, and parking is to be provided for about 25,000 motor vehicles." 364 F. Supp. at 240.

112 *Id.* at 241 (footnote omitted).

113 370 F. Supp. 1101 (D.D.C. 1974).

114 *Id.* at 1109.

estimates of future motor vehicle emissions must be more reliable than is presently possible.

C. *Judicial Developments*

Most of the cases which have involved indirect sources arose on plaintiff's motion for a preliminary injunction to prevent construction. Several were dismissed for failure to show irreparable harm or some other necessary requirement for granting a preliminary injunction. The issue of whether EPA has the legal authority to review indirect sources was either not reached or not raised by the defendants. Therefore, the courts have commented on EPA's indirect source review authority only in passing.[115]

One federal district court has declared that indirect source review is "required" by the Clean Air Act's provision for maintenance of the national standards. In *Metropolitan Washington Coalition v. Department of Economic Development*[116] plaintiffs argued that prior to approving the construction of a new parking garage under the District of Columbia's *stationary* source regulations, the District must determine that the garage's operation will not interfere with the attainment or maintenance of the national air quality standards. The court found that the garage was not a stationary source within the meaning of the District's regulations, and therefore was not subject to the regulations. The court acknowledged that "the presence of the automobiles in and around the proposed facility will affect that location's air quality," but pointed out that neither EPA nor the District had issued *indirect* source regulations designed to cover associated automobile emissions.[117] The court further stated that

> the failure to issue [indirect source] regulations, to the extent that it interfered with the attainment of national ambient air

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115 *See id.* at 1101 (dictum that proposed EPA indirect source regulations did not yet apply to facilities in the District of Columbia); Wuillamey v. Werblin, 364 F. Supp. 237 (D.N.J. 1973) (denying injunction against construction of sports facility for failure to show irreparable harm); Movement Against Destruction v. Volpe, 361 F. Supp. 1360 (D. Md. 1973) (even if highway construction could be prevented by a "land use" or "transportation" control, there was no state implementation plan containing such controls).

116 373 F. Supp. 1096 (D.D.C. 1973).

117 *Id.* at 1099.

> standards in the District or with the District's control strategy in its clean air implementation plan, was illegal under the Clean Air Act of 1970 (42 U.S.C. § 1857 *et seq.*). Natural Resources Defense Council v. EPA, 154 U.S. App. D.C. 384, 475 F.2d 968 (1973).[118]

To the extent that the court in *Metropolitan Washington Coalition* relied on *NRDC* for its determination of illegality, this judgment seems incorrect. As already indicated, *NRDC* required only that the Administrator

> shall inform all states concerned . . . that all states which have not yet submitted an implementation plan fully complying with the requirements of the Clean Air Act of 1970 must submit such a plan by April 15, 1973. The plan must satisfy each and every requirement of Sections 110(a)(2)(A) through (H) if it is to be approved by the Administrator. In particular, it must provide for the attainment of the primary standard as expeditiously as practicable *but in no case later than May 31, 1975*, and it must include "emission limitations, schedules, and timetables for compliance with such limitations, and such other measures as may be necessary to insure attainment and maintenance of such primary or secondary standard, including, but not limited to, land-use and transportation controls."[119]

Thus, the *NRDC* court merely repeated the statutory formula[120] for an approvable implementation plan. It did not interpret the types of regulations required by that formula. Nor did it authorize either indirect source review or "stationary source review for parking garages" based on the "impact of automobiles associated with the garage"[121] as suggested in *Metropolitan Washington Coalition.*

The First Circuit has also ruled directly on the question of whether EPA has the legal authority under the Clean Air Act to regulate indirect sources. In *South Terminal Corp. v. EPA*[122] it held petitioners' argument that "EPA is utterly without statutory

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118 *Id.*
119 475 F.2d at 970-71.
120 42 U.S.C. § 1857c-5(a)(2)(B) (1970).
121 373 F. Supp. at 1099.
122 Civil No. 73-1366 (1st Cir. Sept. 27, 1974).

authority to regulate off-street parking" to be "without merit."[123] Several operators of large parking facilities located in the Boston area had challenged EPA's authority to regulate off-street parking under the Boston Transportation Control Plan. The court suspended the operation of several portions of the Transportation Control Plan pending a more complete review of emissions data, but upheld the Agency's claim of legal authority to regulate parking in order to reduce emissions.[124]

In upholding EPA's claim of statutory authority, the court relied on the "land use and transportation controls" language of the Clean Air Act:[125]

> The terms "land-use" and "transportation controls" are not defined in the Act, but they seem reasonably intelligible in the context. "Land-use" includes the types of regulations normally subsumed under zoning and planning devices. Regulation of the dimensions and quantity of certain types of facilities in a specific urban area is a common use of the zoning tool; and the challenged parking controls are similar, in that they are directives to land owners not to use their land for parking except under specified circumstances. The regulation of parking is also supportable as a transportation control. The plentiful existence of parking facilities creates an incentive to choose motor vehicles; by destroying this incentive, EPA weights the choice more heavily in favor of less polluting transit.[126]

The court did not search the legislative history of the Act for evidence of what Congress meant by the term "land-use and transportation controls"; it only stated that these terms were not defined by the Act.

While it is true that the legislative history of the Act is inconclusive as to EPA's statutory authority to regulate indirect sources, the court's approach of relying on the usual meaning of "land-use controls" or "transportation controls" in other contexts is inadequate. The inquiry into congressional intent should not end

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123 *Id.* at 32.
124 *Id.* at 27-33.
125 *See* text accompanying note 77 *supra.*
126 Civil No. 73-1366 (1st Cir. Sept. 27, 1974) at 32-33.

with the language of the Act but should extend to the examination of the origin and development of the "land-use and transportation controls" language, including relevant comments in the committee reports and floor debate. As the earlier discussion demonstrates, it is doubtful at best that Congress intended EPA to have statutory authority for the regulation of indirect sources,[127] contrary to the construction given the statute by the court. The available evidence seems to indicate that indirect source review was not contemplated by Congress when the Clean Air Amendments of 1970 were passed and that EPA's recent attempts at such review have provoked serious congressional opposition.[128]

Even if the First Circuit holding stands, EPA will face numerous problems in its efforts to implement the regulations. Should these problems prove as serious as suggested in the next section, questions of whether the legislative history authorizes indirect source review will become irrelevant. The real problem at that stage will be to find a substitute strategy acceptable to Congress.

II. Implementation Problems

Any procedure for the preconstruction review of indirect sources must provide a mechanism for answering several questions. First, what sources should be subject to review? Second, how should the reviewing body go about determining whether a particular source will prevent attainment or maintenance of the national standards? Finally, who should be held responsible for any violations of an air quality standard by an "approved" source once constructed, and what sanctions should be imposed on the violator? Although by no means comprehensive, these questions provide a useful analytical framework within which to evaluate the EPA regulations.

A. *Source Selection*

The regulations provide authority to review only those indirect sources whose operation "may cause violations of an implementa-

127 *See* text accompanying notes 81-114 *supra.*
128 *See* note 101 *supra.*

tion plan's transportation control strategy or may prevent or interfere with the attainment or maintenance of an ambient air quality standard."[129] Since virtually every building is a potential indirect source, identifying the class of indirect sources whose associated motor vehicle activity may result in violations of the standards is a serious initial problem. EPA has concluded that this group includes, "but is not limited to," the following sources: (1) highways and roads; (2) parking facilities; (3) retail, commercial and industrial facilities; (4) recreation, amusement, sports and entertainment facilities; (5) airports; (6) office and government buildings; (7) apartment and condominium buildings; and (8) education facilities.[130] While this list appears quite comprehensive, it contains one notable omission — residential housing developments. The Administrator has provided the following explanation for this omission:

> In the Administrator's judgment, a single family tract development does not produce sufficient emission density to yield meaningful results for an air quality impact analysis of an individual development. This is not to say that low density development is more desirable than high density development; however, it is the Administrator's judgment that such low density development is more appropriately and effectively analyzed and dealt with in the comprehensive growth plans related to air quality maintenance.[131]

Family housing tracts may indeed generate only a low pollution density in the tract itself, or in its "vicinity" as the Administrator uses that term.[132] But under EPA's own regulations, each state must have the legal authority to "[p]revent construction, modification, or operation of a facility . . . which directly or indirectly results or may result in emissions of any air pollutant *at any location* which will prevent the attainment or maintenance of a national standard."[133] Automobile activity associated with a housing development is not confined to the streets which serve the development itself. To reach the subdivision it is frequently

129 39 Fed. Reg. 7270 (1974).
130 *Id.* at 7276.
131 *Id.* at 7274.
132 *See* 38 Fed. Reg. 9599 (1973).
133 40 C.F.R. § 51.11(a)(4) (1973) (emphasis added).

necessary for commuters to use one or two main roads. Subdivisions adjacent to inter-state highways are normally served by only one exit ramp. It is on these exit ramps that violations of the national standards are most likely to occur. During rush hour, commuters destined for the same residential development may clog these exit ramps, thereby slowing traffic and increasing total emissions. If a housing tract is large enough, its "associated" motor vehicle population may generate emissions which result in violations of the standards at such locations — which may or may not be in the "vicinity."

In spite of the exclusion of housing tracts, the class of sources subject to review under the Administrator's definition is very broad. It includes virtually all categories of commercial, industrial, and other residential construction. Recall, however, that the regulations limit review to those individual sources which may prevent or interfere with the attainment or maintenance of the national standards.[134] Identifying these particular sources within each class is the most difficult aspect of the source selection problem. To solve this problem, EPA has developed several additional screening criteria which establish a threshold for review for sources in each class.

The first step taken by EPA to limit the number of sources subject to review was to eliminate those sources which do not have an "associated parking area."[135] While a relationship certainly exists between parking capacity and induced motor vehicle activity, the correlation is less than perfect. The regulations proposed in November, 1973, had adopted quite a different approach. They would have required review of any indirect source which:

> (*a*) Is a new parking lot or garage with a parking capacity of 1,000 cars or more, or has a new associated parking area with a parking capacity of 1,000 cars or more; or
>
> (*b*) Is a parking lot or garage being modified to increase parking capacity by more than 500 cars, or has an associated parking area being modified to increase parking capacity by more than 500 cars; or
>
> (*c*) Induces 1,000 or more vehicle trips in any one-hour

134 *Id.*
135 39 Fed. Reg. 7277 (1974).

> period or 5,000 or more vehicle trips in any eight-hour period.[136]

The final regulations do not contain the last test. Its elimination was explained by the Administrator in the preamble to the final regulations:

> Several comments were received criticizing the use of a trip inducement test as being too indefinite a standard to use for determining whether a facility is subject to review. These comments pointed out that in many cases, a developer could not determine with confidence whether his facility is subject to review, since the trip inducement criterion requires that he estimate, several years into the future, how many vehicle trips his facility would induce during peak traffic conditions. Although many developers assess trip inducement as an integral part of their market analysis, a developer should not be placed in legal jeopardy should the actual trips induced upon completion exceed his initial calculations. The Administrator has concluded that a "trip inducement" review test would cause much uncertainty as well as substantial enforcement problems. Thus, the trip inducement standard is not included in the regulations promulgated below, with *parking facility size* being the only indicator of the need for review of sources other than highways and airports.[137]

Whether the uncertainties involved in a trip inducement test constitute a sufficient reason for rejection is questionable. Trip inducement calculations are a necessary component of any parking needs survey. Presumably, these statistics are used by the developer to determine the number of parking spaces required by the facility. If the developer is willing to rely on their accuracy in making parking capacity decisions, there is little justification for rejecting their use as a standard for review. The legal jeopardy problem could be solved by placing the burden of proof on EPA before construction. The developer could be required to submit his estimate of the number of vehicle trips induced by the facility on the condition that the reviewing body would assume responsibility for determining their accuracy. Once the reviewing body was satisfied that it had accurate data, the developer would be

136 38 Fed. Reg. 29895 (1973).
137 39 Fed. Reg. 7271 (1974) (emphasis added).

relieved of any further legal responsibility if the estimates were actually exceeded once the facility was in operation. The problem with this approach is that EPA would suffer a serious resource drain in verifying the accuracy of the data submitted.

The importance of retaining the trip inducement standard becomes clear when the impact of EPA's second precondition for review is examined. Under this second test, only indirect sources with an associated parking area of a certain size are subject to review.[138] Parking facilities containing fewer than the minimum number of spaces would be exempt from review. Reliance on this single standard will produce two results. First, developers will have an incentive to build smaller facilities which require fewer associated parking spaces in order to escape review. Second, developers who wish to build larger facilities will have an incentive to evade review by providing, for example, "public" parking garages not legally "associated" with the facility,[139] and therefore excluded from the count. Review of these "public" facilities separately could be avoided by keeping the number of parking spaces which each provides below the minimum which triggers review.[140]

Even if EPA is able to close this loophole by expanding the associated parking area concept,[141] the question remains whether

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138 Within a Standard Metropolitan Statistical Area (SMSA), a facility would be subject to review if it provided for 1,000 or more parking spaces. If the facility is located outside an SMSA, it would be subject to review if it provided for 2,000 or more spaces. *Id.* at 7277. An SMSA consists of a county or group of counties containing at least one city having a population of 50,000 or more plus adjacent counties which are metropolitan in character and are economically and socially integrated with the central city. U.S. BUREAU OF THE BUDGET, STANDARD METROPOLITAN STATISTICAL AREAS vii-viii (1967).

The Administrator provided no explanation for the use of the SMSA as a location variable; the Implementation Plan Development Regulations had not used this approach. *See* 39 Fed. Reg. 7272 (1974). It seems more logical to use the transportation plan "areas" as the focus for a location classification system.

139 The term "associated parking area" is defined by the regulations to mean "a parking facility or facilities owned and/or operated in conjunction with an indirect source." 39 Fed. Reg. 7276 (1974).

140 Thus, additional "public" or non-associated parking areas could escape review if they contained fewer than 1,000 spaces (fewer than 2,000 outside SMSA's). *Id.* at 7277.

141 There is evidence that the Agency is already moving in this direction. In the preamble to the July 9, 1974 amendments, the Administrator stated that:

> Parking facilities which are fortuitously constructed near an indirect source but over which the owner or operator of the source has no control, and which are not constructed pursuant to an understanding by which the

use of parking lot size as a review criterion will enable EPA to identify successfully those sources which may violate the national standards. In spite of the fact that developers base the size of their parking areas upon the trip inducement test, the size test is a less accurate gauge of emissions than the trip inducement standard. As the turnover rate of, and therefore emissions from, autos increase in a parking area, the planned number of parking spaces may decrease. The trip inducement standard does not suffer this infirmity.

The decision to limit review to those indirect sources with associated parking areas becomes even more questionable because of the size criteria adopted by the Administrator. An indirect source located within a Standard Metropolitan Statistical Area would only be subject to review if its associated parking area provided for 1,000 or more spaces. Use of this number as a threshold for review would exempt virtually all new sources from review in some areas. In Manhattan, for example, over two-thirds of the parking facilities built in conjunction with a commercial structure between 1962 and 1967 contained fewer than 150 spaces.[142] During this period only a handful of parking lots with over 1,000 spaces were constructed, yet over 13,800 off-street parking spaces were added.[143]

The explanation provided by the Administrator for the size criteria contained in the regulation was that:

> facility will serve the indirect source, will not be considered an "associated parking area" of the source. . . . However, if such parking garage were constructed pursuant to an *explicit or even implied agreement* with the shopping center developer to serve the shopping center, it would be considered part of the center's "associated parking area."

Id. at 25294 (emphasis added).

While this "implied agreement" test will certainly help close the loophole, it presents difficult problems of proof. The developer of an "independent" garage in a downtown area will not proceed with the project unless he is relatively certain that there is a demand for additional parking space. In determining whether the demand exists, he will be forced to investigate existing and potential indirect sources in the area. This "needs survey" will inevitably bring the independent developer into contact with the owners or operators of planned, new indirect sources. The determination of whether these contacts have resulted in an "implied agreement" between the independent and the developer of a new indirect source will be extremely difficult.

142 MANHATTAN AUTO STUDY, *supra* note 35, at II-26 to II-27. Data was obtained from the CITY OF NEW YORK, OFFICE OF THE MAYOR, SYSTEMS ANALYSIS OF PARKING REGULATIONS, VIOLATIONS AND ENFORCEMENT ACTIVITIES (1971).

143 *Id.*

> In administering the Act, the Administrator must choose workable tactics considering sound and rational allocation of resources. In the Administrator's judgment, the relatively minimal benefits to be gained by reviewing smaller sources would be greatly outweighed by the resulting detrimental diversion of manpower and resources needed to implement other important aspects of the Act.[144]

Whatever the merits of this decision, EPA's size criteria preclude consideration of the aggregate impact of numerous small sources on air quality. In a heavily developed area the addition of even a small indirect source could induce sufficient additional emissions to put the area in excess of the ambient standards. For this reason the Natural Resources Defense Council has taken the position that "an exemption from review for a given type or size facility is legal only if it can be demonstrated that such exemptions in the aggregate over time will not threaten maintenance of the standards."[145] The NRDC's position appears to require preconstruction review of virtually all indirect sources. Each new source would have to be analyzed in terms of its *marginal* impact on total emissions.

Although EPA has officially recognized the problem,[146] it has decided to defer its solution until after the 1975 deadline for attainment and maintenance of the primary standards. No explanation has been provided for this decision. The Administrator simply "determined that air quality problems associated with an aggregation of smaller sources can be dealt with more effectively and efficiently through the comprehensive growth plans to be submitted by June 1975 than through source-by-source reviews under these indirect source regulations."[147] Indirect source review, according to the Administrator, "should be limited to those [facilities] most likely to cause air quality problems."[148] While the Administrator's distinction between review under the indirect source regulations and review under the comprehensive growth

144 39 Fed. Reg. 7271 (1974).

145 Comments submitted by the Natural Resources Defense Council on the proposed regulations 26 (May 17, 1973) [hereinafter cited as NRDC Comments] (on file at EPA Headquarters in Washington, D.C.).

146 *See* 39 Fed. Reg. 7270-71 (1974).

147 *Id.* at 7271.

148 *Id.*

plans is unclear, the implication that "source-by-source" review will be unnecessary under comprehensive growth plans is subject to substantial doubt.

California is one of the few states which has attempted to deal with the aggregation problem. Its proposed solution would impose an absolute limit on the total emissions of each pollutant within an air basin.[149] Emission "rights" would be allocated by an Air Resources Board, and no indirect source could be constructed which would cause these limits to be exceeded. This is undoubtedly the approach which EPA will be forced to adopt if maintenance of the standards is to be achieved. It is a radical and controversial proposal. EPA has attempted to avoid the issue by requiring only that the states "adopt such measures as may be necessary to assure that growth and development will be compatible with maintenance of the national standards."[150]

As a matter of administrative necessity, EPA may have decided to implement its maintenance strategy in two stages. The first stage is "indirect source review." During this phase only very large facilities will be subject to review. EPA may have reasoned that it could reduce political opposition to the program by initially limiting review to large, highly visible indirect sources. The impact of large facilities on air quality can be demonstrated more easily than the impact of numerous smaller sources. According to this line of reasoning, "indirect source review" constitutes a type of "trial balloon" which will enable both the states and EPA to gauge public and congressional reaction before proceeding with a much more comprehensive review program designed to deal with the aggregation problem.

While this decision may represent a sound political judgment, it is open to attack on legal grounds. The next stage of the maintenance program would not go into effect until 1976.[151] The Clean

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149 STATE OF CALIFORNIA, AIR RESOURCES BOARD, PROPOSED AMENDMENTS TO THE STATE OF CALIFORNIA IMPLEMENTATION PLAN FOR ACHIEVING AND MAINTAINING THE NATIONAL AMBIENT AIR QUALITY STANDARDS 5-6 (Oct. 1973).

150 39 Fed. Reg. 7270 (1974).

151 States have until June 18, 1975, to submit "an analysis of the impact of projected growth on air quality" in those areas where the ambient air quality standards may be exceeded within the next ten years. *Id.* The actual maintenance plans for these areas will take several more months to develop; EPA approval will then

Air Act requires that the states achieve the primary standards by May 31, 1975. The Administrator has already conceded that indirect source review will be inadequate to insure maintenance of the standards in many areas.[152] While the Administrator has the authority to extend the deadline by two years, he may do so only if the state has already imposed all "reasonably available" control measures and is unable to achieve the standards by 1975.[153] It would therefore appear that the Administrator's decision to defer implementation of the more comprehensive review program necessary to insure maintenance beyond 1975 violates both the Clean Air Act and the court order in *NRDC*.[154]

In *NRDC*, the court specifically rejected EPA's attempt to defer the submission of transportation control plans beyond the statutory deadline. The court stated that

> [t]he Act plainly does not permit extensions of the statutory time for submission by each state of an implementation plan which will permit attainment of the standards by 1975. Whether or not the technology for implementation of or compliance with the plan is available is a matter for the grant of extensions under Sections 110(e) and (f) after the plan is filed.[155]

Presumably, the same reasoning would apply to an attempt to defer submission of plans adequate to insure maintenance of the standards. The Natural Resources Defense Council has already filed a petition for review of the final regulations.[156] One of the alleged errors raised in the petition is EPA's failure to require submission of an adequate maintenance plan prior to the 1975 deadline. If the court accepts NRDC's argument, EPA may be forced to implement review under the comprehensive growth plans before 1976. This development would effectively frustrate

require another 3-4 months. In short, the earliest possible effective date for these regulations would be February or March, 1976.

152 *Id.*

153 42 U.S.C. § 1857c-5(e)(1) (1970).

154 This conclusion can be avoided only if the Administrator argues that comprehensive growth plans have not been "reasonably available," but will become so by June, 1975, when those plans are to be submitted.

155 NRDC v. EPA, 475 F.2d 968, 970 (D.C. Cir. 1973).

156 NRDC v. EPA, Civil No. 74-1235 (D.C. Cir., filed Feb. 14, 1974).

the Agency's efforts to limit initially the scope of indirect source review.

In summary, the source selection procedure presently adopted by EPA will not insure that all of the indirect sources which may violate the national standards will undergo review. The numbers used by EPA to establish a threshold for review are too large and have little or no relationship to existing ambient air quality levels. Use of the criteria to exclude individual sources from review is certain to invite litigation — litigation which the Agency will probably lose.

B. *The Standard of Review*

The legal test which must be satisfied before construction of a new indirect source can be approved was changed significantly as a result of the July 9 amendments[157] to the February regulations.[158] The latter had directed the Administrator to withhold approval for the construction or modification of an indirect source if it would:

> (a) Cause a violation of the control strategy of any applicable state implementation plan; or
>
> (b) Delay the attainment of the national standards for carbon monoxide in any region beyond the date specified for any such region in Part 52 of this chapter; or
>
> (c) Cause a violation of the national standards for carbon monoxide in any region where the attainment date specified for any such region in Part 52 of this chapter will have passed at the time of completion of the indirect source.[159]

The July amendments substituted a new two-part test which retained clause (a) above, but replaced clauses (b) and (c) with the following language: "Cause or exacerbate a violation of the national standards for carbon monoxide in any region or portion thereof."[160] Both tests pose special problems of interpretation. Unfortunately, the Administrator has provided only limited guidance

157 39 Fed. Reg. 25292-301 (1974).
158 *Id.* at 7277.
159 *Id.*
160 *Id.* at 25298.

as to how the standards should be applied to individual sources.[161] The information which is available suggests that EPA does not intend to apply the standards literally.

The first test, common to both the February and July regulations, is perhaps the most ambiguous. State control strategies which could possibly be violated by the construction of an indirect source include those contained in the transportation control plans. These strategies are designed to supplement the Federal Motor Vehicle Control Program[162] in those areas where emissions reduction produced by use of catalytic converters[163] will be inadequate to achieve the primary standards by 1975. Among the transportation controls approved by EPA are improved mass transit, exclusive bus lanes, parking surcharges, and upgraded inspection and maintenance programs.[164] It is hard to imagine how the construction of an indirect source could "violate" any of these control strategies.

The only transportation control strategy which the construction of an indirect source might "violate" would be direct restrictions on parking supply. Only a few states have actually adopted such restrictions. New York is perhaps the leading example. The New York transportation control plan requires a 30-

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161 This lack of guidance and EPA's failure to define more precisely the standard of review leave the regulations open to court attack on the ground that the test is too vague. The First Circuit in the *South Terminal* case "disapproved" the standard of review contained in the Boston Transportation Control Plan for new parking facilities:

> We are concerned, however, by the standardlessness of subsection (d). The clause permits denial of a permit unless the functionary passing on such requests decides that the facility will "not interfere with the attainment or maintenance of applicable Federal air quality standards . . . ." This may be a form of words meaning that the facility meets the limits on parking spaces set forth elsewhere in the plan; on the other hand it may mean anything the permit-giver decides. The regulation does not indicate how "interference" is to be judged, nor does it state who must bear the burden of showing noninterference. The prospective applicant for a permit is utterly without guidance as to what he must prove, and how. And the standard is so vague that it invites arbitrary and unequal application.

Civil No. 73-1366 (1st Cir. Sept. 27, 1974) at 35.

162 *See* note 32 *supra.*

163 The installation of catalytic converters by the auto manufacturers is required and enforced by EPA. State regulation of emissions from new motor vehicles is prohibited by the Clean Air Act. 42 U.S.C. § 1857f-6a(a) (1970).

164 38 Fed. Reg. 16551-53 (1973).

40 percent reduction in the number of off-street parking spaces.[165] The plan also provides for a "freeze" on the granting of new permits to operate off-street parking lots. The difficult question is whether this "freeze" extends to off-street parking lots "associated" with new indirect sources. If it does, the construction of any new indirect source with associated parking would presumably violate both the transportation control plan and the federal indirect source regulations.

It is highly doubtful that EPA would interpret the regulations to preclude all new indirect source construction. The Administrator has acknowledged that review of smaller indirect sources would be justified under the "parking management" section of a transportation control plan, but he has never suggested that all new construction be prohibited.[166] Assuming that some new construction is permitted in the New York metropolitan area, additional criteria will have to be developed to identify those facilities which will violate the parking reduction strategy. Otherwise, an indirect source could only be built if it made no provision for associated parking and was not otherwise prohibited.

The problem is especially difficult because the New York plan bans all on-street parking.[167] Those indirect sources which make no provision for parking will not be able to rely upon on-street parking to handle even the parking needs of visitors. Visitors and employees alike will be forced to compete for a continually shrinking number of "public" garage spaces. Therefore, unless the location is adequately served by mass transit it may be very difficult for people to reach the indirect source at all.

Surely, strict application in New York City of the first test contained in the indirect source regulations would severely limit, if not halt, growth. This would undoubtedly be politically unacceptable. And yet, should EPA refuse to apply the "freeze" on new off-street parking to parking areas "associated" with a new indirect source, there is virtually no chance that New York will achieve the primary standards on schedule.[168]

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165 NEW YORK PLAN, *supra* note 104, at A-29, 10-5.
166 *See* 39 Fed. Reg. 7274 (1974).
167 NEW YORK PLAN, *supra* note 104, at A-29.
168 According to the *New York Plan*, the parking reduction strategy is the "pri-

Part (b) of the February standard of review would have prohibited the construction of any indirect source which would "[d]elay the attainment of the national standards for carbon monoxide in any region beyond the date specified for any such region in Part 52 of this chapter."[169] Theoretically, emissions growth during the implementation period was considered in the development of the original state plans.[170] Indirect source review was not included in those plans. The control measures which were included should have produced sufficient emission reductions to insure that both existing and future sources meet the primary standards by the 1975 deadline.[171] Therefore, no indirect source would have been denied a permit because it would "delay the attainment of the national standards."

In reality, the problem is more complicated. First, the emissions reduction figures provided by EPA for each transportation control measure are, at best, rough estimates. EPA has stated that "States have had practically no experience with transportation control measures as a means of dealing with air quality problems . . . ."[172] The framers of the *New York Plan* made a similar point:

> The admitted shortcomings of analytical models, combined with the dynamic nature of the problem, make it imperative that the effort initiated in preparing this plan be maintained to provide a continuing index of the effectiveness of the plan and an instrument for implementing strategies needed to replace measures which failed to produce the projected air quality improvements.[173]

Thus, the degree of emissions reduction attributed to each strategy cannot be considered conclusive evidence of the actual impact it will have on air quality. Second, the control measures are, to a large extent, interdependent. As the *New York Plan* points out:

> The reductions shown, which indicate achievement of the standards by 1975, are based on *all* of the primary strategies

mary strategy" for achieving the primary standards. Failure to achieve the 30-40% reduction in off-street parking will therefore create a substantial shortfall in emissions reductions. *Id.* at 10-3 to 10-4.

169 39 Fed. Reg. 7277 (1974).

170 *See* 40 C.F.R. § 51.12(a) (1973).

171 *See, e.g.*, NEW YORK PLAN, *supra* note 104, at 2-5.

172 37 Fed. Reg. 10844 (1972).

173 NEW YORK PLAN, *supra* note 104, at 1-1.

> being applied together. If, for example, parking restrictions . . . are not implemented successfully, other strategies, notably vehicle turnover . . . will yield lower reductions in pollutants.[174]

Third, the projections of emissions growth between 1973 and 1975 are necessarily tentative. Finally, total emissions depend on a number of variables whose impact is virtually impossible to estimate in advance. Even if EPA possessed accurate estimates of the number of additional vehicle miles which would be generated by new indirect sources between 1973 and 1975, it would be unable to predict ambient air quality with any reasonable degree of confidence. As the *New York Plan* emphasized:

> It is important to note that the characteristics of diffusion at a high traffic area are often such that emissions and ambient levels are not related in a simple linear manner. Carbon monoxide concentrations are a function not only of the rate of vehicle emissions but also of the dilution which results from turbulence generated by vehicular motion. . . .
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> . . . Investigations by New York City . . . show that dropping traffic speed from 7 mph to 1 mph can cause a 300 percent increase in emissions expressed as grams per mile; the simultaneous decrease in ventilation produced by vehicle-generated turbulence has been found to enhance the air quality impact of these emissions by as much as another 300 percent. Since these two effects act in concert, a 900 percent increase could result if other factors remained constant.[175]

The foregoing considerations suggest that it is highly unrealistic to assume that the control measures contained in the transportation control plans will be adequate to achieve the primary standards by 1975. Thus, any incremental addition to emissions induced by a new indirect source may delay the attainment of the national standards.[176]

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174 *Id.* at 10-3.

175 *Id.* at 2-2 to 2-3.

176 The real question is whether EPA intended that indirect source review serve as a supplemental control measure for the attainment of the national standards. In the preamble to the February regulations, the Administrator stated:

> The primary purpose of the regulations is to serve as an element in an overall strategy for maintenance. The regulations are not technically part of any control strategy to attain the standards in those areas in which the ambient air standards are now being exceeded. Nevertheless, they will

On its face, the new test promulgated in July, 1974[177] only serves to confirm this conclusion. The new test makes explicit what was implicit in the old test — to permit the construction of a new indirect source in an area which is already in violation of the standards will "interfere with the attainment of the standards as expeditiously as practicable." The Administrator explained the reason for the adoption of the new test in the preamble to the July regulations:

> The test as stated in the February regulation could have permitted temporary new violations of the carbon monoxide standard to be created until the specified attainment date. This would be inconsistent with the requirements of the Clean Air Act, which requires attainment of primary ambient standards "as expeditiously as practicable," not merely by the statutory deadline. To allow violations to be created or exacerbated by the construction of a new source is consistent neither with this mandate nor with 40 CFR 51.18, since to allow a new source to create new violations would "interfere" with the attainment of the standards as expeditiously as practicable.[178]

According to this interpretation, the new test would (1) prohibit the construction of a new indirect source which will create a "new" violation of the primary carbon monoxide standards, and (2) prohibit the construction of a new indirect source in any area which is already in violation of the standards. While this second conclusion may follow logically from the "exacerbate" language of the new test, EPA has still not retreated from the position it took in the February preamble that some new source construction could be permitted in areas where the primary standards are being violated. On that occasion the Administrator declared:

> To the extent that air quality levels at the site of a proposed indirect source are expected to continue to threaten

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serve a useful corollary purpose of assisting in the attainment of the standards in such areas.

39 Fed. Reg. 7273 (1974).

Unfortunately, this explanation does not answer the question of whether individual sources should be denied permits in order to "assist" in attaining the ambient standards where it is obvious that the transportation controls will not assure attainment of the primary standards by the statutory deadline.

177 *Id.* at 25298.

178 *Id.* at 25295.

> the national standards, this condition may be due to existing adverse traffic conditions which may be corrected. If such a situation is corrected, a facility may be allowed to construct if the owner can demonstrate that the additional induced traffic will not cause the local traffic flow to return to its initial condition.[179]

This suggestion seems ineffectual for several reasons. It is unlikely that significant opportunities for additional improvements in traffic flow will be available following implementation of the transportation control plans. Traffic flow improvement is the least expensive transportation control measure and has already been adopted in most cities.[180] But even if additional opportunities to improve traffic flow were available, it is questionable whether such measures would insure a permanent improvement in air quality. Indeed, EPA has acknowledged the problem:

> Various traffic flow improvement measures, including operational improvement of existing roads, have been proposed by many States on the basis that the resulting higher traffic speeds will substantially reduce pollutant emissions.
>
> There are indications that the resulting improvement in air quality will be short-lived, since street improvements tend to induce additional traffic. With higher traffic volumes, total emissions will increase. Within a year or two the emissions may in fact be at higher levels than if the traffic flow improvement measures had not been implemented at all.[181]

Despite the transitory nature of such traffic control improvements, EPA does not require an air quality impact analysis of the facility beyond the first year of operation.[182] The rationale for this decision was explained as follows: "It is the Administrator's judgment that increased carbon monoxide emissions due to growth of mobile source activity associated with a specific indirect source (other than a highway or airport) would be more than offset by the Federal motor vehicle control program."[183]

Given the actual performance of federal emission control de-

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179 *Id.* at 7275.
180 *See* 40 C.F.R. pt. 52 (1973).
181 38 Fed. Reg. 16552 (1973).
182 39 Fed. Reg. 7275 (1974).
183 *Id.* at 7275-76.

vices,[184] this assumption is fatuous. Furthermore, even if actual emissions are reduced, other factors, such as decreased vehicle speed, may more than offset the expected improvement. It is difficult to avoid concluding that EPA's exception which permits construction of new indirect sources in areas already violating ambient standards promises something which cannot be delivered. Either the precondition for the exception does not exist, *i.e.*, adverse traffic conditions have been corrected previously, or the air quality will be sacrificed because of increased traffic volume.

A second rationale advanced by the Administrator to permit the construction of an indirect source at a location where the ambient standards are being violated is "net VMT reduction."[185] According to this line of reasoning, construction of an indirect source could be approved if traffic generated by the source would displace an equal or greater amount of traffic generated at other locations. This argument was first advanced by the International Association of Shopping Centers in their comments on the proposed regulations:

> While shopping complexes tend to concentrate a large number of *parked* non-emitting vehicles in one location, one stop shopping reduces the vehicular miles travelled and gasoline consumption. Small, scattered retail stores, on the other hand require more traveling, more emission, in the same ambient air area.
>
> . . . Shopping centers have less effect in endangering air quality standards than concentrations of commercial establishments along suburban streets.[186]

While this logic may be sound, it does not alter the fact that both old test (c) and new test (b) are expressed in terms of impact on air quality, not the impact of a new source on net vehicle miles generated. While the net vehicle miles generated may be reduced, the concentration of emissions from vehicles attracted by a shopping center may still create violations of the ambient air

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184 *See* MANHATTAN AUTO STUDY, *supra* note 35, at I-19 to I-20.

185 "VMT" refers to the vehicle miles traveled within an air quality control region. A net VMT reduction would mean that fewer total miles would be driven within the region as a whole as a result of specific changes in certain areas of the region. *See* 38 Fed. Reg. 16552 (1973).

186 I.C.S.C. Comments, *supra* note 10, pt. III, at 19-20, 21.

quality standards. The result may be that customers of a shopping center will be exposed to much higher emission levels on the roads leading to the facility than would have been the case if retail shopping establishments were more dispersed.[187]

The displacement argument also assumes that the shopping center will replace existing retail establishments, rather than merely supplement them. Although a shopping center will undoubtedly draw some business away from existing retail outlets, it is unlikely that the latter will be forced to close. The addition of a shopping center may only serve to encourage more comparison shopping, thus increasing the number of vehicle miles generated.

In short, both of the rationales suggested by EPA to justify the construction of an indirect source at a location where the primary standards are already being violated seem weak. That EPA has even advanced them suggests that the Agency does not intend to interpret its own tests rigorously.

There is yet another reason why the new July test may make it virtually impossible for the Agency to avoid the "no growth consequences" of its own regulations. The test requires the Administrator to prohibit the construction of an indirect source if it will "cause or exacerbate a violation of the national standards for carbon monoxide *in any region or portion thereof.*"[188] "Region" refers to the air quality control regions established by the Administrator under the authority of the Clean Air Act.[189] These regions cover relatively large areas and frequently include more than one state. This language is important because the air quality impact of an indirect source is not limited to the area immediately surrounding that source. As the Natural Resources Defense Council pointed out in its comments on the proposed regulations:

> In virtually every metropolitan area where the Set II pollutant standards [automotive-related pollutants] are now being exceeded there are demonstrable examples of facilities

187 This, of course, depends on the size and character of the highways leading to the shopping center. If the shopping center is served by a good network of superhighways, rather than secondary roads which would become quickly congested, the shopping center's patrons may not be exposed to higher emission levels.

188 39 Fed. Reg. 25298 (1974) (emphasis added).

189 40 C.F.R. § 51.1(m) (1973).

> which attract substantial numbers of vehicles from many miles away, resulting in pollution causing congestion along arteries and streets miles from the facility. A facility which attracts even a relatively small number of vehicles along a route which is already being utilized to a high percentage of its capacity will significantly increase pollution, for traffic analyses demonstrate that each additional vehicle placed on a heavily traveled route contributes to a disproportionately large decrease in average vehicle speed, which increases emissions. It matters not whether the near capacity routes are in the vicinity of the facility or far removed from it; if any significant numbers of the vehicles attracted to the facility travel those routes they may interfere with attainment or maintenance of the standards.[190]

EPA may therefore have to review the air quality impact of a new indirect source at numerous locations throughout the air quality region. The Agency recognizes this possibility, but emphasizes that the "purpose of the review . . . is primarily to insure that the national standards will not be violated in the *vicinity* of a major new facility."[191] The Agency has interpreted "vicinity" as the area within ¼ mile of the indirect source.[192] Yet, the Administrator has conceded that "the tests specified in subparagraphs (4) and (6)[193] in no way restrict the Administrator as to the location of the air quality impact analysis."[194] It might be more accurate to say that the test, as currently outlined, *requires* the Administrator to consider the air quality impact of the facility "in any region or portion thereof."

Nonetheless, the Administrator has decided to require detailed traffic data governing only "the immediate vicinity of the indirect source."[195] More comprehensive data will only be requested on "a case-by-case basis," and only "where the facility might pose a threat to the air quality standards at such locations."[196] The prob-

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190 NRDC Comments, *supra* note 145, at 16.
191 38 Fed. Reg. 9599 (1973) (emphasis added).
192 39 Fed. Reg. 25293 (1974).
193 See text accompanying note 159 *supra* for text of subparagraph (4). Subparagraph (6), which applies to highways and is similar to subparagraph (4), can be found at 39 Fed. Reg. 7278 (1974).
194 *Id.* at 25293.
195 *Id.*
196 *Id.*

lem with this approach is that it provides Agency officials with no criteria for triggering an expanded review. It also leaves the Agency open to the charge that approval of a proposed source is invalid because the Agency failed to consider the air quality impact of the source at location "x." On the other hand, a region-wide test will leave EPA with a massive "vehicle tracing" problem which could upset even the most sophisticated review process.[197]

In conclusion, the new regulations, if applied rigorously, may well halt construction of new indirect sources in most metropolitan areas. If an area is already in violation of the national primary standard (as most metropolitan areas are),[198] construction of an additional indirect source will almost certainly "exacerbate" the existing violation. It is unlikely that the developer of a new source could institute traffic flow improvements significant enough both to eliminate the existing violation and to allow for the additional vehicles attracted. Second, even if the immediate area in which the new source is to be constructed is not now in violation of the standards, it is quite possible that cars attracted to the new source will create or exacerbate violations on major roadways leading to the source.

It should also be apparent that the consequent effect on growth would be politically unacceptable. In an effort to avoid this result, EPA has announced that it will rely on "traffic flow characteristic guidelines"[199] in making its determination whether a particular source will violate the regulatory standards. These guidelines are designed to "relate traffic demand and capacity considerations to ambient carbon monoxide impact, by use of approximate atmospheric diffusion models . . . and/or by any other

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197 It is difficult to exaggerate the potential complexity of the problem. Large office buildings, for example, may draw private autos from a 25-30 mile radius. According to the regulations, the incremental impact of these autos on carbon monoxide levels would have to be evaluated at every potential point of violation along the routes which these autos would be expected to take in order to reach the office building. This analysis could involve literally hundreds of intersections and other points where violations are likely.

198 Already, 37 metropolitan areas are required to implement transportation control plans to supplement the Federal Motor Vehicle Control Program in order to assure attainment of the primary standards by the statutory deadline. 4 ENV. REP. CURRENT DEV. 457 (1973).

199 39 Fed. Reg. 25296 (1974).

reliable analytic method."[200] If the proposed facility meets these criteria, EPA automatically presumes that it will not "create or exacerbate a violation of the national standards . . . in any region or portion thereof."[201] While this approach will reduce EPA's administrative burden and presumably permit most facilities to be approved,[202] it seems not to conform with the standards contained in the regulation itself. The guidelines represent a very simplified, crude approach to estimating total emissions.[203] They are open to challenge on numerous technical grounds which are beyond the scope of this Note.[204] Even EPA has conceded that:

> [t]his provision [use of the traffic flow characteristic guidelines] does not modify the reviewing agency's responsibility to make the determination that the ambient air quality standards will be attained and maintained . . . . In cases where the Administrator finds that the use of the traffic flow characteristics would not be compatible with the tests for review under the regulation, he is required to consider a diffusion model in making his final determination.[205]

If the Administrator can make such a determination, presumably a court which is dissatisfied with the result obtained using

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200 *Id.* at 25298-99.

201 *Id.* at 25298.

202 Support for this conclusion is found in the preamble to the February regulations: "Thus, even though the national standards for carbon monoxide may presently be exceeded at some locations in a region, most facilities subject to this regulation which are designed to produce the requisite traffic flow characteristics should still be allowed to construct." *Id.* at 7275.

203 Section 3 of the EPA guidelines makes this clear. "In order to develop the reasonably simple methodology whereby the criteria for traffic volume, capacity and v/c [volume divided by capacity] can be ascertained, it has been necessary to sacrifice flexibility in evaluating a source's impact by making a number of assumptions." EPA, INTERIM PROCEDURES FOR DETERMINING THE IMPACT OF TRAFFIC FLOW CHARACTERISTICS § 3.0, at 12 (1974) (on file at EPA Headquarters in Washington, D.C., and with *Harvard Journal on Legislation*).

204 Probably the most serious error involves the location of a "reasonable receptor." A "receptor" is a person. The guidelines assume that an average receptor would be positioned at least 10 meters from the edge of the traffic lane. All of the analysis is predicated on this assumption. In reality, many city sidewalks are directly adjacent to the street. As a result, an average pedestrian would be exposed to carbon monoxide fumes emanating from exhaust pipes just a few feet away, not more than 30 feet away, as EPA assumes. Since carbon monoxide is a highly localized problem and disperses rapidly, even within a small area, the position of the "reasonable" receptor becomes very important for purposes of establishing a violation of the standards. *See id.* § 2.1, at 5-6.

205 39 Fed. Reg. 7275 (1974).

the guidelines could require a full-scale review. EPA may be able to devise guidelines which will permit it to approve most new facilities, but a determined challenger can almost certainly upset these approvals by going to court and demonstrating the weakness of the Agency's technical determination.[206] While the guidelines may serve to buy the Agency more time, a court willing to look carefully at the approval process will almost certainly be able to find a basis for invalidating the approval. EPA may then be forced to adopt the "no growth" approach which it has sought to avoid, and against which congressional action would very likely be forthcoming.[207]

C. *Liability and Enforcement Provisions*

One of the most difficult questions raised by the regulations is whether the owner of an indirect source is liable for violations of the national standards caused by his facility once it is in operation. Would approval of the facility by the review authority relieve the owner of any further liability for subsequent violations of the standards? Despite the importance of these questions, the regulations provide no clear answer. The evidence available is both ambiguous and contradictory.

Section 51.11(a)(4) of the regulations provides that each state must have the legal authority to "[p]revent construction, modification, or *operation* of a facility . . . which directly or indirectly results or may result in emissions of any air pollutant at any location which will prevent the attainment or maintenance of a national standard."[208] This language does not distinguish between those indirect sources which have received the approval of a reviewing authority and those which have not. It appears to establish a simple empirical test: does operation of the indirect source result in a violation of the national standards? However, the language requires only that the state have the legal authority to pre-

206 *See* South Terminal Corp. v. EPA, Civil No. 73-1366 (1st Cir. Sept. 27, 1974) at 25-26.

207 Congress was roused to such an intervention when EPA attempted to impose surcharges on automobile parking as part of the transportation control plans. The episode suggests that the Agency's actions will be watched very closely in the future. *See* text accompanying notes 98-102 *supra*.

208 40 C.F.R. § 51.11(a)(4) (1973) (emphasis added).

vent operation of a facility which violates the standards. It does not explicitly require the state to seek injunctive relief against such a facility.

Other language in the regulations suggests that the distinction is more than academic. Section 52.22(b)(11) seems to limit the liability of the owner of an approved source to violations of the conditions contained in the permit:

> Any owner or operator who fails to construct and operate an indirect source in accordance with the application, as approved and conditioned by the Administrator, or any owner or operator of an indirect source subject to this paragraph who commences construction or modification thereof after December 31, 1974, without applying for and receiving approval hereunder, shall be subject to the penalties specified under section 113[209] of the Act and shall be considered in violation of an emission standard or limitation under section 304[210] of the Act.[211]

Unless the permit contains a provision that the source shall not be operated in violation of the national standards, this section does not seem to authorize injunctive or other legal action against a facility because its operation causes a violation of the standards.

The confusion is compounded by § 52.22(b)(13) which provides that "[a]pproval to construct or modify shall not relieve any owner or operator of the responsibility to comply with the control strategy and all local, State, and Federal regulations which are part of the applicable state implementation plan."[212] The control strategy of a state implementation plan is designed to insure the attainment and maintenance of the national standards. Any source, whether direct or indirect, which interferes with the attainment or maintenance of the standards is presumably in violation of the control strategy. The only way to escape this conclusion is to argue that indirect sources are not explicitly covered by the control strategy of a state. This argument seems weak, however, since the

209 Section 113(c)(1) of the Clean Air Act provides for fines of not more than $25,000 per day or imprisonment for not more than one year for violation of the new stationary source provisions of the Act. 42 U.S.C. § 1857c-8(c)(1) (1970).

210 Section 304 of the Clean Air Act provides for citizen suits against any polluter or the Administrator. *Id.* § 1857h-2(a).

211 39 Fed. Reg. 7279 (1974).

212 *Id.*

state plans were specifically amended to include regulation of indirect sources as part of the required control strategy.[213]

The failure of EPA to require the owner of an indirect source to conduct post-construction monitoring of air quality suggests, however, that EPA does not intend to pursue an aggressive enforcement program. The proposed regulations would have given the director of the reviewing authority power to require such monitoring.[214] The Administrator has provided no explanation for his decision to drop the requirement: "The final regulation clarifies the circumstances under which the reviewing agency may condition permits and eliminates the responsibility for the post-construction air quality monitoring by the applicant. If needed, such monitoring should be conducted by the reviewing agency."[215]

This decision to place responsibility for post-construction monitoring on the reviewing authority will virtually guarantee a weak enforcement program. First, no reviewing agency will be anxious to implement an extensive monitoring program which will only serve to uncover its previous miscalculations. Second, even if the reviewing body did wish to conduct post-construction monitoring, budget limitations (in the absence of a congressional commitment of funding) would probably preclude such activity in most locations. Only the owner of an indirect source is likely to have sufficient financial resources to cover the cost of monitoring operations.

Even if a violation of the standards could be traced to an indirect source, a legal basis for holding the owner responsible for the violation is indeed elusive. The regulations make it quite clear that the reviewing agency, not the developer, has the responsibility for analyzing the air quality impact of the proposed facility. EPA argues that "[s]ince developers normally do not have the expertise to perform such an analysis, [reviewing agency analysis] will ensure that such calculations are properly made, and that the air quality estimates will be made at receptor locations considered important by the reviewing agency."[216] While the rationale for using reviewing agency analysis may be sound, such a procedure

213 *Id.* at 7270.
214 38 Fed. Reg. 29896 (1973).
215 39 Fed. Reg. 7276 (1974).
216 *Id.* at 7275.

serves to provide the developer with an excellent defense to any action charging him with liability for violations of the standards once the facility is in operation. If the reviewing authority's projections turn out to be wrong, the developer can argue that the authority, not he, is at fault. And the difficulty in enforcing the regulations against an indirect source in operation which induces emissions in violation of the standards is exacerbated by the limited options then available to the owner or developer.[217]

Conclusion

Indirect source regulation faces a very uncertain future. Despite Agency assurances, there is a very real question whether indirect source review is authorized by the Clean Air Act. The legislative history is at best ambiguous. Even if the courts hold that EPA may review indirect sources, Congress may well amend the statute to eliminate such authority.[218] The administration has prepared a series of amendments[219] which would delay key deadlines in the Act and restrict EPA's authority to implement transportation control measures in many urban areas. Should Congress suspend transportation controls in these areas, it is unlikely that EPA will be allowed to substitute indirect source review as an alternative control strategy for achieving the primary standards. Halting all emissions growth by placing a moratorium on the construction of new indirect sources is even less acceptable politically than attempting to control emissions from existing sources. And even if such a moratorium were possible, it would not produce sufficient reductions in emissions to permit attainment of the primary standards.[220]

*Robert J. Rauch**

217 *See* note 105 *supra* and accompanying text.

218 *See* H.R. 15858, 93d Cong., 2d Sess. (1974), which would amend the Clean Air Act to prohibit EPA from requiring an indirect source emission review as part of any applicable implementation plan.

219 4 ENV. REP. CURRENT DEV. 2004-10 (1974).

220 Indirect source review would leave unaffected emissions from existing direct sources which are the major problem in attaining the standards.

*Member of the Class of 1975 at Harvard Law School. Former environmental aide to Senator William Proxmire (D.-Wis.); Assistant Legislative Director (1972) and Director of Legal Services (1973) for Friends of the Earth; Special Assistant to the Deputy Administrator of the Environmental Protection Agency (1974).

BOOK REVIEW

PRESIDENTIAL POWER AND ACCOUNTABILITY: TOWARD A NEW CONSTITUTION. By *Charles M. Hardin,* Chicago: The University of Chicago Press, 1974. Pp. 246, index. $7.95.

Political observers since Woodrow Wilson[1] have debated the merits of introducing a parliamentary system or some other form of "party government" to American politics.[2] Advocates of such a change cite several basic advantages of parliamentary government:[3] it allows for a quick dismissal of governments that have lost public confidence; it ensures cooperation and communication between the executive and legislative branches; it presents the electorate with a choice between ideologically cohesive parties; it discourages reverence of the ministerial executive. Weighing against these factors are several favoring our present system:[4] the President is guaranteed time to develop initiatives; the chances of a rubber-stamp Congress are minimized; and broad-ranging dissent can be more robust because it is not funnelled into narrow channels by party discipline.

The advocates of an American parliamentary system face a still greater obstacle, however: two centuries of attachment to an executive system and, especially since August 9, deep and broad satisfaction that "the system works." As one observer has summed it up, a change to parliamentary government does not have "even a chance of happening without a revolution."[5]

Yet one should not dismiss books advocating parliamentary government, of which Professor Hardin's work is the most recently published example, out of hand. As Lord Keynes pointed out,[6]

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1 W. WILSON, CONGRESSIONAL GOVERNMENT (1885).

2 *See, e.g.,* H. FINER, THE PRESIDENCY: CRISIS AND REGENERATION 303-10 (1960); Q. QUADE & T. BENNETT, AMERICAN POLITICS: EFFECTIVE AND RESPONSIBLE? (1969); Carleton, *Our Congressional Elections: In Defense of the Traditional System,* 70 POL. SCI. Q. 341 (1955); Hargrove, *What Manner of Man?,* in *Choosing the President* 14-16 (J. Barber ed. 1974); Ranney, *Toward a More Responsible Two-Party System,* 45 AM. POL. SCI. REV. 488 (1951).

3 G. REEDY, THE TWILIGHT OF THE PRESIDENCY 183 (1970).,

4 Hargrove, *supra* note 2.

5 G. REEDY, *supra* note 3, at 184.

6 J. M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 383-84 (1936).

theoreticians often develop their ideas long before practitioners see any use for them. Although lacking immediate political impact, the debate over parliamentary government remains a valid one.

Professor Hardin's approach in this debate involves two steps. For most of the book he sets out a number of general problems, arguing that they are of such significance as to require fundamental constitutional change along party government lines for their solution. He then concludes with a detailed constitutional scheme of party government.

The particular plan suggested by Hardin need not concern one at length since it adds little of note to the debate over a party government system in the United States. Under Hardin's plan (pp. 182-97), the Senate would be given only dilatory power. Congress and the President would be elected simultaneously to four year terms, subject to a no-confidence vote. The party winning the Presidency would get a bonus of 100 at-large Representatives, with the second-place party receiving 50, but fewer if necessary to give the President's party a majority of five. Each party's at-large candidates would be nominated by 41-member central committees, empowered also to reject local nominees who challenge party discipline.

Numerous practical flaws can be found in this plan, among them the confusion that would result as 41 party leaders tried to rank 50 others in order of priority, or as the public tried to choose between 101-member chain gangs. Not surprisingly, then, Hardin himself appears to have rather little confidence in the specifics of his own plan,[7] wisely inviting the reader to focus attention instead on the broader asserted need for some form of party government.

Even limited to his broader arguments, however, Professor Hardin's extravagant claims for party government inflict further damage on the tenor of the debate. Like a carnival barker Hardin implies that his system will cure not only the cancers growing

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7 "I am less sure of the proposals for reform than I am of the previous analysis" (p. 182). The superficiality of the particular plan to Hardin's primary concerns is indicated by other proposals for party government that he has made in past years, which include quite different specific plans. *See* H. FINER, *supra* note 2, at 338-40.

on American politics but the warts as well. He spends much of the book analyzing a number of problems, including: (1) the dangers of presidential whimsy, (2) excessive bureaucratic power, (3) interest groups' control of Congress, and (4) the ineffectiveness of the public's voice in government (p. 10). Certainly each of these four is worthy of the time spent on them. What one notes in each case, however, is a constant tendency to overstate the problem coupled with a party government solution containing too many practical flaws to match Hardin's crusading rhetoric.

Moreover, not only is Hardin unpersuasive in contending that party government is the ultimate panacea; he never confronts the most critical question for any radical reformer — why fundamental constitutional change would prove more effective than a less drastic series of adjustments in the present governmental machinery. The risks to the stability of our government involved in rewriting the Constitution are sufficiently great[8] that anyone proposing such a course must carry the very heavy burden of convincing the reader that more moderate alternative solutions are sufficiently poor as to justify more radical measures. A survey of the problems Hardin proposes to solve through party government suggests numerous alternative solutions never even raised in Hardin's book, much less refuted.

As the title of the book suggests, Hardin pays closest attention to the problem of presidential whimsy. He is disturbed by the extent to which governmental policy has been shaped by presidential hunches and unexamined assumptions. American policies in Vietnam are presented (pp. 49-62) as prime examples of vital decisions determined largely in this way. The suggested corrective is formal concentration of congressional opposition under an opposition party leader, the runner-up presidential candidate, "whose questions the President must answer and whose analyses of situations and proposals the President must consider" (p. 64).

There are several difficulties with this analysis. First, Hardin overstates the problem. Though he correctly decries "the Difficulty of Arguing With Presidents" (ch. 2), he should not have

8 *See, e.g.*, Carson, *Disadvantages of a Federal Constitutional Convention*, 66 MICH. L. REV. 921 (1968); Note, *Limited Federal Constitutional Conventions: Implications of the State Experience*, 11 HARV. J. LEGIS. 127 (1973).

ignored "the great importance of having [a President] act on [his] affirmative hunches"[9] unless he believes that governance can be reduced to a science.

Second, in arguing that an opposition leader would solve the problem, Hardin seems to assume that if the President adopts a bad policy his chief adversary would adopt a good one. Yet concentrating the opposition might well increase the chances of a policy's gaining bi-partisan support without critical examination, for the carping of independent voices would be muted. Hardin is satisfied that party government would not stifle dissent, merely transfer it to the party caucus. This may be a vain hope, however, if party discipline is to be toughened in a profession whose watchword already is "To get along, go along."[10]

Finally, one must ask whether the problem as stated by Hardin is basically insoluble. If a President's closest advisers cannot tell him he's a damn fool, it is doubtful that one he expects to oppose him on partisan grounds can transmit the same message. Indeed, not only Presidents but nearly all powerful executives — more broadly, most people with large egos — are difficult to dissuade from their whims.[11] Rather than trying to do so by vast constitutional changes, most reformers tend to concentrate on ensuring that those hunches that do not work will be restrained.

Thus, proposals to cut back the magisterial character of the Presidency have gained increasing support, their goals being to alter a President's attitude toward his office, to make him more receptive to different ideas and criticisms, and to limit his power to act on his hunches independently of Congress. Public attention has recently been focused on congressional efforts to cut back public expenditures for private presidential properties[12] and to

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9 Felix Frankfurter to Franklin Roosevelt, Mar. 6, 1935, in ROOSEVELT AND FRANKFURTER: THEIR CORRESPONDENCE, 1928-1945 at 257 (M. Freedman ed. 1967). Frankfurter was speaking of F.D.R. specifically.

10 Speaker Rayburn's advice to freshman Congressmen, quoted in J. CLARK, CONGRESS: THE SAPLESS BRANCH 55 (1964).

11 This is as true in a parliamentary system as in an executive one. Neville Chamberlain and Edward Heath are two examples from the British experience.

12 *See* HOUSE COMM. ON GOVERNMENT OPERATIONS, EXPENDITURE OF FEDERAL FUNDS IN SUPPORT OF PRESIDENTIAL PROPERTIES, H.R. REP. No. 1052, 93d Cong., 2d Sess. 6 (1974). Pub. L. No. 93-554, signed on Dec. 27, 1974, limits presidential transition expenditures to $200,000.

limit the size of the White House staff.[13] Possibly more significant in the long run would be amendments to the broadcast fairness doctrine to require regular replies by congressional leaders to televised presidential addresses[14] and legislation requiring executive officers to testify before Congress and limiting executive privilege.[15] Presidents themselves also can find ways of cutting their office down to size; President Ford's congressional testimony is an example.[16]

Congress is capable within our present constitutional framework of devising direct statutory checks on presidential policy formulation as well. It already has moved to some extent against impoundment and Vietnam-like situations in the Congressional Budget and Impoundment Control Act[17] and the War Powers Resolution.[18] Some have proposed further legislation to require congressional approval of executive agreements.[19]

Hardin might have produced a better work had he considered these approaches to the problem of presidential whimsy as alternatives to risky constitutional change. Instead he swings the trusty party government broadsword against his next dragon, which he tags "bureaucracy-out-of-control." Bureaucracies dominate policy formulation within their bailiwicks, he says, and find obsequious partners in their respective congressional committees.

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13 H.R. 14715, 93d Cong., 2d Sess. (1974), passed the House, 120 CONG. REC. H5658 (daily ed. June 25, 1974), and then passed the Senate with amendments, 120 CONG. REC. S12969 (daily ed. July 18, 1974), but final agreement was not reached before the end of the session.

14 *See* Puntigam, *Television and the Congress: Preserving the Balance*, 26 FED. COM. B.J. 209 (1973); *Hearings on S.J. Res. 209 Before the Subcomm. on Communications of the Senate Comm. on Interstate and Foreign Commerce*, 91st Cong., 2d Sess. (1970).

15 H.R. 12462, 93d Cong., 2d Sess. (1974). *See* HOUSE COMM. ON GOVERNMENT OPERATIONS, AMENDING THE FREEDOM OF INFORMATION ACT TO REQUIRE THAT INFORMATION BE MADE AVAILABLE TO CONGRESS, H.R. REP. NO. 990, 93d Cong., 2d Sess. 6-10 (1974).

16 *Hearings on the Pardon of Richard Nixon Before the Subcomm. on Criminal Justice of the House Comm. on the Judiciary*, 93d Cong., 2d Sess. (1974); 32 CONG. Q. WEEKLY REP. 2907 (1974).

17 Pub. L. No. 93-344, 88 Stat. 297 (1974).

18 Pub. L. No. 93-148, 87 Stat. 555 (1973). *See* Comment, *The War Powers Resolution: Statutory Limitation on the Commander-in-Chief*, 11 HARV. J. LEGIS. 181 (1974).

19 E. HUGHES, THE LIVING PRESIDENCY 287 (1973). *See generally* Berger, *The Presidential Monopoly of Foreign Relations*, 71 MICH. L. REV. 1 (1972).

Thus only if congressional leadership and opposition were each made strong and unified would bureaucratic dogmas be considered — and countered — in the national context (pp. 116-18).

Hardin's prime example of this second problem, again the war in Vietnam, illustrates the same tendency to overstatement that we noted above. While the military bureaucracy did play a major role in setting Vietnam policies, Hardin fails to demonstrate how it wholly dominated. If there had been a President, or even a Congress, with a mind set against the war, our involvement would have ended years earlier.[20] To ascribe the lack of such a President or Congress to military brainwashing and the influence of military contracts in key congressional districts raises many interesting questions (pp. 76-96), but simply ignores the role played by individual decisionmakers and by Middle America's gut feeling against a "precipitate withdrawal."

Hardin also might have considered the extent to which excessive bureaucratic power is a problem endemic to any large organization.[21] Where such is the case, broad changes in the overall governmental framework are likely to accomplish far less than more delicate adjustments within the existing framework. For example, there could be more discretion in the hiring and firing of top bureaucrats; perhaps a rotating Senior Civil Service, as proposed by the Second Hoover Commission,[22] would be helpful. A merger of departments, with procedures providing for direct responsibilities from the professional as well as the political heads to the President, has also been proposed.[23]

Hardin may well be correct, of course, in contending that one major cause of excessive bureaucratic power in policy areas like

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20 Although opposition to American operations in Indochina had been growing for some time, it was not until May 10, 1973, that the House amended an appropriations bill, H.R. 7447, 93d Cong., 1st Sess. (1973), to cut off funding for such activities. 119 CONG. REC. H3604-05 (daily ed. May 10, 1973). *See* Pub. L. No. 93-50, 87 Stat. 99 (1973).

21 *See* L. GAWTHROP, BUREAUCRATIC BEHAVIOR IN THE EXECUTIVE BRANCH 11-14, 19 (1969).

22 COMMISSION ON ORGANIZATION OF THE EXECUTIVE BRANCH OF THE GOVERNMENT (1953-55), PERSONNEL AND CIVIL SERVICE 37-44 (1955).

23 OFFICE OF MANAGEMENT & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, PAPERS RELATING TO THE PRESIDENT'S DEPARTMENTAL REORGANIZATION PROGRAM: A REFERENCE COMPILATION (rev. ed. Feb. 1972); Fortas, untitled article in E. HUGHES, *supra* note 19, at 335.

Vietnam is the ineffectiveness of Congress. His book documents a number of cases where Congress has failed both to make tough policy decisions and to fulfill properly its oversight role over executive departments (pp. 82-87, 119-27). But in advocating as his solution the centralization of congressional power under two powerful party leaders, Hardin overlooks the fact that this approach has already been tried, and was dramatically rejected in 1910 after two decades of Tom Reed and Joe Cannon.[24]

He also overlooks alternative methods of making Congress more effectively representative, many of them much more likely actually to gain implementation than is a return to the discredited pre-1910 system. The seniority system in Congress has come under increasing attack in recent years, particularly by those advocating the election of committee chairmen.[25] Some also have proposed to break up the "cozy little triangles" of lobby-committee-bureaucracy by limiting a Congressman's tenure on any one committee.[26] Numerous other reforms designed to restructure committee jurisdictions along rational lines, streamline congressional legislative procedures, and make congressional oversight procedure more effective, came to the fore in the 93d Congress during the fight over the Bolling Resolution,[27] but receive no mention in Hardin's work.

Closely related to the problem of bureaucracy is Hardin's third major concern: interest groups' control of Congress. In presenting a centralization of congressional leadership as "the best hope to achieve political control on behalf of the public" over labor and other interest groups (p. 140), Hardin again conflicts with the

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24 *See* G. GALLOWAY, HISTORY OF THE HOUSE OF REPRESENTATIVES 52-56, 134-41 (1961); Robinson, *Proposed Reforms: Party Responsibility versus Legislative Independence,* in CONGRESSIONAL REFORM: PROBLEMS AND PROSPECTS 164-65 (J. Clark ed. 1965).

25 The 93d Congress took a first step toward broader changes in the seniority system by adopting new procedures for electing committee chairmen and ranking members, 31 CONG. Q. WEEKLY REP. 69 (1973). For a summary of various reform proposals, *see* B. HINCKLEY, THE SENIORITY SYSTEM IN CONGRESS (1971).

26 *Cf.* D. JAMES, THE CONTEMPORARY PRESIDENCY 212-16 (2d ed. 1974).

27 H.R. Res. 988, 93d Cong., 2d Sess. (1974). The much more limited Hansen version passed the House, 120 CONG. REC. H10169 (daily ed. Oct. 8, 1974). *See* HOUSE SELECT COMM. ON COMMITTEES, COMMITTEE REFORM AMENDMENTS OF 1974: REPORT TO ACCOMPANY H.R. RES 988, H.R. REP. No. 916, pt. 2, 93d Cong., 2d Sess. (1974). *See generally* G. GOODWIN, THE LITTLE LEGISLATURES (1970).

experience of the Congresses of Speakers Reed and Cannon, in which special interest groups played quite dominant roles.[28] He also has trouble dealing with the parliamentary experience of Britain, since the conventional wisdom is that "pressure groups are more powerful in Britain than in the United States."[29] Hardin does attempt to get around this latter dilemma by maintaining that British interest groups are kept in check by administrators and technicians who are in turn under the direct control of the political party leaders (pp. 130-38). However, even if one accepts the contention that British interest groups are less powerful because they must deal with strong national parties as a unit rather than dominating individual, regionally-based legislators, the explanation may well lie less in the structural differences between the two systems than in the greater importance of money in American elections.[30]

Focusing in this way on the importance of political campaign contributions to interest group power in the United States, Hardin's third problem also might prove susceptible to at least partial solution by statute. While the campaign reform bill passed by the 93d Congress[31] applies only to presidential elections, continues the existing high limits on group contributions, and still puts a premium on private fund-raising, proposals for additional reform range all the way to a total ban on private funds and government regulations requiring free radio and television time for candidates.[32] Whether even these would be sufficient to deal with the problem of excessive interest group pressure might be debated.[33]

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28 "During the two decades divided by the year 1900 the problem of private power confronted the American people openly on a scale unmatched in the history of the republic." G. MCCONNELL, PRIVATE POWER & AMERICAN DEMOCRACY 30 (1966).

29 Beer, *Pressure Groups and Parties in Britain*, 50 AM. POL. SCI. REV. 1, 3 (1956). *See also* S. BEER, BRITISH POLITICS IN THE COLLECTIVIST AGE 77-79 (1965); R. T. MCKENZIE, BRITISH POLITICAL PARTIES (2d ed. 1963); G. ROBERTS, POLITICAL PARTIES AND PRESSURE-GROUPS IN BRITAIN (1970).

30 *See* N. POLSBY & A. WILDAVSKY, PRESIDENTIAL ELECTIONS: STRATEGIES OF AMERICAN ELECTORAL POLITICS 34-43 (2d ed. 1968).

31 Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443 (Oct. 15, 1974).

32 *See Hearings on S. 1103, S. 1954 and S. 2417 Before the Subcomm. on Privileges and Elections of the Senate Comm. on Rules and Administration*, 93d Cong., 1st Sess. 225-52 (1973).

33 An argument can be made that the power of many interest groups is exerted as much through political organization as through campaign contributions. *See* 32 CONG. Q. WEEKLY REP. 1947-52 (1974).

Unfortunately, however, Hardin's discussion merely states the problem, discusses the British example, and then assumes a constitutional solution without any consideration of alternative approaches.

The final basic problem identified by Hardin as solvable by a parliamentary system is what he calls "the travail of public opinion": the public, he maintains, pays insufficient attention to politics to make intelligent decisions on specific issues (pp. 142-62). This may well be the case. But it is difficult to see how Hardin can then claim that the public "uniquely qualifies" for a much larger task — selecting in one stroke a government and, by default, an opposition (p. 160). What Hardin's point really comes down to is a reduction in the public role in the selection of individual candidates. Indeed, his scheme includes nomination of presidential candidates by a party's single-district Representatives and candidates (p. 184), a plan remarkably similar to the congressional caucus method abandoned as undemocratic a century and a half ago.[34]

There are severe practical disadvantages as well in limiting the public's direct role in electoral politics. Given the non-ideological pattern of American voting,[35] the emphasis in Hardin's system likely would be on capturing the perceived middle, and the parties might well drift into indistinguishable blandness. The problem would be aggravated if the safety valve of third parties were plugged by Hardin's at-large bonus plan for the top two parties. Further, with public control over candidate selection reduced, there would be no guarantee that issues of real popular concern would be raised, or that candidates would accurately gauge the public's feelings on the apparent ones.

Hardin's presentation of a new political structure as a solution to what he perceives as an uninformed public exposes the fundamental flaw in his entire thesis. Regardless of the merits or demerits of a parliamentary system in relation to our present constitutional framework, no structural proposal could ever fulfill the grand claims Hardin advances, eliminating problems as fundamental as public attitudes toward government. Without increased

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34 *See* G. POMPER, NOMINATING THE PRESIDENT: THE POLITICS OF CONVENTION CHOICE 14-22 (1966).

35 *See, e.g.*, V.O. KEY, THE RESPONSIBLE ELECTORATE (1966). Hardin discusses and disputes Key's analysis (p. 152).

public vigilance and understanding, institutional reforms — sweeping or limited — are of little value;[36] with it, such reforms become less important for an effective democracy to function.

In sum, Professor Hardin should have heeded Lord Bryce's warning that "a large scheme made all at once in . . . the spirit of conscious experiment" is unwise because "historical development is wiser than the wisest man."[37] Bryce, of course, was no Pangloss; he recognized the importance of a "succession of small improvements, each made comformably to existing conditions and habits."[38] While *Presidential Power and Accountability* serves a valuable purpose in focusing on some significant problems in American government and raising the possibility of constitutional solutions, the reader will have to look elsewhere for the hard work still remaining to be done on the "small improvements" required.

*Richard D. Friedman**

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36 E. HUGHES, *supra* note 19, at 287-88.

37 J. BRYCE, THE AMERICAN COMMONWEALTH 25-26 (G.P. Putnam's Sons ed. 1959), *quoted in* E. HUGHES, *supra* note 19, at 281.

38 *Id.*

* Member of the Class of 1976 at Harvard Law School.