ARTICLE

PRIVATE SUITS AGAINST BROKER-DEALERS:

A PROPOSAL TO LIMIT THE AVAILABILITY OF RESCISSORY RELIEF FOR MISREPRESENTATIONS IMPLIED BY THE SHINGLE THEORY

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Introduction

A broker-dealer is subject to four provisions of the Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] which generally prohibit fraud in securities transactions. As a "person," a broker-dealer is subject to Securities Act Sections 12(2)[3] and 17(a)[4] and Exchange Act Section 10(b)[5] and Rule 10b-5[6] thereunder; as a "broker" and "dealer,"[7] he is subject to Exchange Act Section 15(c)(1)[8] and Rule 15c1-2[9] thereunder. All of these provisions apply to sales of securities, and the Exchange Act provisions apply to purchases as well. While each provision uses

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1 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as Securities Act or Sec. Act].

2 15 U.S.C. §§ 78a-78hh (1970) [hereinafter cited as Exchange Act or Sec. Ex. Act].

3 15 U.S.C. § 77*l*(2) (1970) [hereinafter cited as § 12(2)]. Section 12(2) does not literally prohibit fraud; rather, it provides that a seller who engages in fraud is civilly liable to his purchaser. For the sake of simplicity, however, the general antifraud provisions will sometimes in this paper be characterized, without differentiation, as prohibiting certain conduct.

4 15 U.S.C. § 77g(a) (1970) [hereinafter cited as § 17(a)].

5 15 U.S.C. § 78j(b) (1970).

6 17 C.F.R. § 240.10b-5 (1972) [hereinafter cited as Rule 10b-5].

7 Section 3(a)(4) of the Exchange Act, 15 U.S.C. § 78c(a)(4) (1970), defines the term "broker" as "any person engaged in the business of effecting transactions in securities for the account of others . . . ." Section 3(a)(5) of the Exchange Act, 15 U.S.C. § 78c(a)(5) (1970), defines the term "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. . . ." The term "broker-dealer," as used in this article, means a person or entity regularly performing the functions of both a broker and a dealer.

8 15 U.S.C. § 78o(c)(1) (1970).

9 17 C.F.R. § 240.15c1-2 (1972) [hereinafter cited as Rule 15c1-2]. Exchange Act § 15(c)(1) limits the application of Rule 15c1-2 to over-the-counter transactions.

different language to define the conduct which it forbids, all four prohibit misrepresentations of material facts.

On their face, the four general antifraud provisions impose upon broker-dealers only obligations to which all other traders of securities are equally subject. Yet the nature of their profession affords broker-dealers more frequent and varied opportunities than ordinary traders to take unfair advantage of the public. Moreover, the customers of a broker-dealer tend in practice to rely upon his integrity and diligence whether or not he acts as their common law agent. Such considerations motivated Congress, in drafting the Exchange Act, to include provisions which directly regulate the securities industry.[10] They also motivated the Securities and Exchange Commission,[11] a few years after the enactment of the Exchange Act, to formulate an analysis expanding the obligations which the general antifraud provisions impose upon broker-dealers.

This analysis, which has become known as the "shingle" theory, was first articulated by the Commission in a broker-dealer revocation proceeding in 1939.[12] The Commission ruled that a broker-dealer who sells securities at a price not reasonably related to the prevailing market price of the securities violates Section 17(a) and Rule 15c1-2.[13] The Commission's holding was sweeping in scope:

> Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession. It is neither fair dealing, nor in accordance with such standards, to exploit trust and ignorance for profits far higher than might be realized from an informed customer.[14]

The shingle theory received judicial approval in *Charles Hughes & Co. v. SEC*,[15] and has been reaffirmed by the Commission on numerous occasions.[16]

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10 *See, e.g.*, Exchange Act §§ 7, 8, 11, 15, 15A, and 17, 15 U.S.C. §§ 78g, h, k, o, and q (1970).

11 Hereinafter cited as Commission or SEC.

12 Duker & Duker, 6 S.E.C. 386 (1939).

13 *Id.* at 389.

14 *Id.* at 388-89 (footnote omitted).

15 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

16 *See, e.g.*, Harvey H. Shields, Jr., 39 S.E.C. 608, 609 (1959); Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949); and cases cited in 10 S.E.C. ANN. REP. 74 n.56 (1944).

The consequences of the shingle theory extend far beyond the prohibition of unreasonable markups. The theory provides that, whenever a broker-dealer engages in a securities transaction with a customer, he impliedly represents that he will act fairly and in accordance with professional standards. A broker-dealer impliedly makes this representation notwithstanding the absence of either any fiduciary obligation to his customer at common law or any express representation whatsoever. The representations of fairness and adherence to trade custom are implied, and the attendant obligations imposed, merely by virtue of a broker-dealer's engaging in business or "hanging out his shingle."

This general representation encompasses a variety of particularized representations by a broker-dealer that he will not engage in specific unfair or unprofessional practices. Whenever a broker-dealer engages in a practice which is either unfair or contrary to trade custom, he contravenes one of these implied representations. If the particular implied misrepresentation is material, it violates the general antifraud provisions. In this manner the shingle theory expands the obligations which the general antifraud provisions impose upon broker-dealers beyond the obligations to which ordinary traders are subject.[17]

When the Commission formulated the shingle theory in 1939, it presumably did not even consider the possibility that a broker-dealer might be civilly liable for implied misrepresentations.[18] For many years thereafter the shingle theory was used almost exclusively in the Commission's administrative proceedings, appellate reviews of those proceedings, suits by the Commission for injunctions, and criminal cases. In the last decade, however, cus-

17 For a general discussion of the shingle theory, see 3 L. Loss, SECURITIES REGULATION 1482-93 (2d ed. 1961) [hereinafter cited as Loss]; E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS § 16-1 (1965); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 876-81 (1972).

18 Rule 10b-5 was not adopted until 1942, and implied private rights of action were not first recognized under § 17(a) and Rule 15c1-2 until 1949. Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949). In 1939, therefore, the only provision under which a broker-dealer could conceivably have been civilly liable for an implied misrepresentation was § 12(2). But the phrase "by means of a prospectus or oral communication" might well have seemed to render § 12(2) inapplicable to *implied* misrepresentations, although federal courts subsequently held otherwise. In any event, the Commission's natural preoccupation with its own responsibilities suggests that it did not consider the question of civil liability for implied broker-dealer misrepresentations.

tomers have begun to employ the shingle theory more frequently in private actions against their broker-dealers under the general antifraud provisions, collecting civil damages for the whole range of broker-dealer actions implied by the theory to be misrepresentations.

This increased use of the shingle theory in private suits by customers requires an assessment of the implications of civil liability under the general antifraud provisions for implied broker-dealer misrepresentations. Such an assessment is especially appropriate at the present time. The American Law Institute currently is drafting a proposed Federal Securities Code[19] designed not only to codify but also to revise substantively the existing federal securities legislation.[20] One of the principal objectives of the draftsmen of the Code, moreover, is to rationalize the civil liabilities expressly or impliedly created by the existing legislation.[21]

The assessment which follows will begin by classifying the broker-dealer representations which are implied by virtue of the shingle theory into two groups — advisory and commercial. The relief to which the general antifraud provisions presently entitle a customer who proves an implied misrepresentation by his broker-dealer will then be examined. Following is an assessment of the propriety of rescissory relief — the relief to which a customer is entitled for an implied broker-dealer misrepresentation under the current general antifraud provisions — for each class of implied broker-dealer misrepresentation. The article will conclude by recommending new Federal Securities Code provisions. If adopted, these provisions would render rescissory relief unavailable for implied commercial misrepresentations, for which such relief is improper.

I. Classes of Implied Broker-Dealer Misrepresentations

The Commission has identified a considerable number of broker-dealer representations as implied by virtue of the shingle

19 ALI Federal Securities Code (Reporter's Revision of Text of Tentative Drafts Nos. 1-3, 1975) [hereinafter cited as Federal Securities Code or FSC].

20 Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27, 37-38 (1969).

21 *Id.* at 34-35.

theory. As noted above, the first to be identified was the reasonableness of a broker-dealer's mark-up — the difference between the price at which he sells securities to a customer and the prevailing market price of the securities.[22] Similarly, the Commission has ruled that a broker-dealer impliedly represents that his markdown — the difference between the price at which he purchases securities from a customer and the prevailing market price of the securities — is reasonable.[23] A broker-dealer also has been held to represent impliedly that he has a reasonable basis for his recommendation to purchase or sell particular securities;[24] that securities which he recommends are suitable for the particular customer;[25] and that he will disclose any special interests which

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22 Duker & Duker, 6 S.E.C. 386, 389 (1939). This representation is implied when a broker-dealer sells as a principal (dealer).

The determination of prevailing market price or a substitute therefor is often difficult. For discussions of this problem and the principles which the Commission has developed to resolve it, see 3 Loss, at 1491-92; 6 *id.* at 3686-91; E. WEISS, *supra* note 17, §§ 16-3 to -7; Eadington, *Regulation of Over-the-Counter Markups: A Reappraisal of Present Policy*, 1 LOYOLA U. (L.A.) L. REV. 128, 135-40 (1968); Jacobs, *supra* note 17, at 940-45; Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 372-73 (1970).

The National Association of Securities Dealers (NASD) has promulgated an ethically-oriented rule which also prohibits unreasonable markups. NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154. The NASD has indicated that markups in excess of five percent of prevailing market price usually are unreasonable. CCH NASD SEC. DEALERS MANUAL ¶ 2154 at 2055-58. The Commission has announced that this guideline is applicable to non-member (SECO) broker-dealers as well as to NASD members. SEC Sec. Ex. Act Release No. 9420 at 7 (Dec. 20, 1971).

The implied representation of a reasonable markup assumes special forms in certain contexts. *See, e.g.*, J.J. Ledone, 30 S.E.C. 804 (1950) (oil royalty dealer impliedly represents that his selling price is reasonably related to reasonable estimates of oil recoverable from tract underlying royalty interest sold as well as to prevailing market price); Russell L. Irish, 42 S.E.C. 735, 740-42 (1965), *aff'd*, 367 F.2d 637 (9th Cir.), *cert. denied*, 386 U.S. 911 (1966) (dealer who sells mutual fund shares impliedly represents that no substantial reduction in sales load can readily be obtained).

23 *See, e.g.*, D. Earle Hensley Co., 40 S.E.C. 849, 851-52 (1961); Associated Sec. Corp., 40 S.E.C. 10, 15 (1960), *aff'd*, 293 F.2d 738 (10th Cir. 1961); W.T. Anderson Co., 39 S.E.C. 630, 634-36 (1960). This representation is implied when a broker-dealer purchases as a principal (dealer).

24 *See, e.g.*, Armstrong, Jones & Co., 43 S.E.C. 888, 896 (1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Richard Bruce & Co., 43 S.E.C. 777, 779-81 (1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969); Walston & Co., 43 S.E.C. 508, 512 (1967); Floyd Earl O'Gorman, 43 S.E.C. 83, 85-86 (1966); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963).

25 *See, e.g.*, Richard N. Cea, 44 S.E.C. 8, 16 (1969); Best Sec., Inc., 39 S.E.C. 931, 933-34 (1960).

The suitability doctrine is also embodied in ethically-oriented rules promulgated may influence his recommendation.[26] Likewise, according to the Commission, he impliedly represents that he will not engage in boiler room activity,[27] accept a customer's funds or securities while insolvent,[28] or excessively trade ("churn") a customer's ac-

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by the New York and American Stock Exchanges, the NASD, and the Commission. *See* N.Y. Stock Exch. Rule 405, 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2405 (the "know your own customer" rule); Am. Stock Exch. Rule 411, 2 CCH AM. STOCK EXCH. GUIDE ¶ 9431; NASD Rules of Fair Practice Art. III, § 2, CCH NASD SEC. DEALERS MANUAL ¶ 2152; Sec. Ex. Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1972) (SECO rule).

26 *See, e.g.*, Haley & Co., 37 S.E.C. 100, 106 (1956) (failure to disclose that salesman was president of issuer of securities recommended); R.D. Bayly & Co., 19 S.E.C. 773, 784 (1945) (failure to disclose that partner of broker-dealer was director and officer of the issuer of securities which broker-dealer recommended be sold).

The Commission has promulgated two rules expressly requiring written disclosure of certain interests of a broker-dealer in his recommendations. Exchange Act Rule 15cl-5, 17 C.F.R. § 240.15cl-5 (1972), requires disclosure where the broker-dealer is controlled by, controls, or is in joint control with the issuer of a security he recommends. Exchange Act Rule 15cl-6, 17 C.F.R. § 240.15cl-6 (1972), requires disclosure of participation or other financial interest in the primary or secondary distribution of securities the purchase or sale of which the broker-dealer recommends. *See also* Sec. Ex. Act Rule 15cl-4, 17 C.F.R. § 240.15cl-4 (1972) (disclosures which are required to be included in written confirmations).

The representation implied by virtue of the shingle theory, of course, is broader in scope than Rules 15cl-5 and 15cl-6. William I. Hay, 19 S.E.C. 397, 408 (1945). The representation is not confined to the disclosure of interlocks between a broker-dealer and issuer. Recent federal court decisions indicate that a broker-dealer must also disclose his short position or market-maker status with respect to recommended securities. Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir.), *cert. denied*, 397 U.S. 989 (1970) (short position); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (market-maker status).

27 *See, e.g.*, Seaboard Sec. Corp., 43 S.E.C. 118, 119-21 (1966); Mac Robbins & Co., 41 S.E.C. 116 (1962), *aff'd sub nom.*, Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Best Sec., Inc., 39 S.E.C. 931 (1960). Boiler room activity consists essentially of an intensive sales campaign wherein a broker-dealer recommends to a large number of customers the purchase of securities of one or a very few issuers, notwithstanding the fact that the broker-dealer lacks a reasonable basis for his recommendation and that the securities may be unsuitable for particular customers. The securities typically are low-priced and speculative and are recommended by telephone or direct mail. *See* Mac Robbins & Co., *supra* at 119-20, 132; Best Sec., Inc., *supra* at 933-34; E. WEISS, *supra* note 17, § 16-11.

28 *See, e.g.*, Fliederbaum, Mooradian & Co., SEC Sec. Ex. Act Release No. 7176, at 1 (Nov. 29, 1963); Thompson & Sloan, Inc., 40 S.E.C. 451, 454 (1961); Earl L. Robbins, 39 S.E.C. 847, 849 (1960); Batkin & Co., 38 S.E.C. 436, 446 (1958). The Commission considers a broker-dealer to be insolvent either if he is unable to meet his obligations as they mature or if his liabilities exceed his assets. Fliederbaum, Mooradian & Co., *supra*; Thompson & Sloan, Inc., *supra*. The Commission has recently indicated that a broker-dealer may also contravene his implied representation of solvency by engaging in business while in violation of the New York Stock Exchange's net capital requirements. *See, e.g.*, Joseph V. Shields, Jr., SEC Sec. Ex. Act Release No. 8484 at 2 (Jan. 3, 1969).

count over which he exercises effective control.[29] Finally, a broker-dealer has been held to represent impliedly that he will promptly execute orders[30] and consummate transactions,[31] and will not misappropriate a customer's funds or securities.[32] These last three implied representations overlap to a considerable extent in application.[33]

The preceding enumeration exhausts neither the broker-dealer representations which the Commission has identified to date as implied by virtue of the shingle theory[34] nor others which the Commission and the courts might ultimately identify. However, it does indicate the diversity of the representations which have been or could be identified as implied by virtue of the shingle theory.

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29 *See, e.g.*, R.H. Johnson & Co., 36 S.E.C. 467, 476-80 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); Behel, Johnsen & Co., 26 S.E.C. 163, 168 (1947); Norris & Hirshberg, Inc., 21 S.E.C. 865, 890 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

Exchange Act Rule 15cl-7(a), 17 C.F.R. § 240.15cl-7(a) (1972), expressly prohibits the churning of accounts with respect to which the broker-dealer is "vested" with any discretionary power. By virtue of the shingle theory, the general antifraud provisions also prohibit churning whenever the broker-dealer "is in a position to determine the volume and frequency of transactions by reason of the customer's willingness to follow [his] suggestions. . . ." Norris & Hirshberg, Inc., *supra*.

30 *See, e.g.*, Leo G. MacLaughlin Sec. Co., SEC Sec. Ex. Act Release No. 7783 at 1 (Jan. 5, 1966); Reynolds & Co., 39 S.E.C. 902, 913 (1960); William Rex Cromwell, 38 S.E.C. 913, 915 (1959).

31 *See, e.g.*, Vincent Associates Ltd., SEC Sec. Ex. Act Release No. 6806 at 1 (May 16, 1962); SEC Sec. Ex. Act Release No. 6778 at 1 (April 16, 1962); Carl J. Bliedung, 38 S.E.C. 518, 521 (1958); Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949). A broker-dealer consummates transactions by delivering to his customer the securities purchased or the proceeds from the sale.

32 *See, e.g.*, Thompson & Sloan, Inc., 40 S.E.C. 451, 454 (1961) (conversion of customer's securities); William Rex Cromwell, 38 S.E.C. 913, 915 (1959) (conversion of customer's funds).

33 Misappropriation usually involves the contravention of one or both of the implied representations concerning prompt execution and prompt consummation in addition to the one concerning misappropriation itself. A broker-dealer who misappropriates a customer's funds or securities which he holds in connection with a purchase or sell order necessarily fails promptly to consummate the transaction. If he misappropriates the funds or securities before he has executed the order, he necessarily fails promptly to execute the order as well as consummate the transaction. Only the misappropriation of a customer's funds or securities held otherwise than in connection with a purchase or sell order contravenes solely the implied representation concerning misappropriation.

34 For other enumerations of implied broker-dealer representations which the Commission has identified, see SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, 238-40, 302 (1963); 3 Loss, at 1488-90; 6 *id.* at 3682-85; E. WEISS, *supra* note 17, § 16-1; Jacobs, *supra* note 17, at 879.

Notwithstanding the diversity of these representations, it is submitted that each of them may be grouped into two distinct classes. The first class consists of representations which a broker-dealer impliedly makes in his capacity as an investment adviser. These "advisory" representations relate to a broker-dealer's recommendations with respect to particular securities, and collectively guarantee that his recommendations will be reliable. Customers presumably attach importance to a broker-dealer's implied advisory representations in selecting particular securities to purchase or sell.

For example, suppose that a customer asks his broker-dealer to recommend a good stock for purchase. The broker-dealer recommends purchase of a certain corporation's stock, and the customer, acting upon that recommendation, authorizes the purchase. In fact, however, the broker-dealer knows nothing of that corporation's fiscal well-being, having merely seen its name in a flyer received in the mail that morning. Here the broker-dealer contravenes the implied representation of having a reasonable basis for his recommendation; the implied representation is advisory, for the customer reasonably attaches importance to it in deciding to purchase that particular stock.

Similarly, of the ten remaining implied broker-dealer representations enumerated above, three others qualify as advisory representations — those concerning suitability, undisclosed special interests, and boiler room activity. That the first two of these representations qualify as advisory representations is readily apparent. Since boiler room activity involves the recommendation, without a reasonable basis therefor, of securities which may be unsuitable for particular customers to whom the recommendation is made,[35] the implied guarantee against boiler room activity also qualifies as an advisory representation.

The second class consists of representations which a broker-dealer impliedly makes in his capacity as a trader of securities for his own or his customer's account. These "commercial" representations relate to a broker-dealer's performance of his routine commercial functions, and collectively guarantee that his per-

35 *See* note 27 *supra.*

formance will conform to trade custom. Customers presumably attach importance to a broker-dealer's implied commercial representations in deciding to trade either with or through him. Since implied commercial representations relate neither to particular securities nor to a broker-dealer's recommendations with respect to particular securities, however, customers cannot reasonably attach importance to such representations in selecting particular securities to purchase or sell.

For example, suppose that a customer requests his broker-dealer to purchase certain securities which are traded over-the-counter. The broker-dealer purchases the securities but adds a 75% commission to the price he paid for them. Not knowing the current market price of those securities, the customer assumes the total price quoted to be reasonable and pays the broker-dealer the full amount. Here, the broker-dealer's conduct contravenes the implied representation of reasonable markups. While the customer presumably would attach importance to this representation in deciding whether or not to trade with or through this broker-dealer, the broker-dealer's conduct would not influence a reasonable customer in his decision whether or not to purchase those securities at all.

Five of the remaining six implied broker-dealer representations all qualify as commercial representations — reasonable markdowns, churning, prompt execution, prompt consummation, and misappropriation. Since the implied representation of solvency is essentially a guarantee by a broker-dealer that he will be financially able to consummate transactions into which he enters,[36] it too is a commercial representation.

II. The Present Availability of Rescissory Relief for Implied Broker-Dealer Misrepresentations

Under the general antifraud provisions as presently drafted, a plaintiff who establishes the elements of a private cause of action is entitled, for all types of broker-dealer misrepresentations, to rescissory relief — rescission or damages measured so as to pro-

36 *See* Earl L. Robbins, 39 S.E.C. 847, 849 (1960).

duce the substantial equivalent of rescission.[37] Rescissory relief thus compensates a plaintiff for his market losses — decreases (or increases) in the market value of the securities which the plaintiff purchased (or sold) between the date of the transaction and the date of rescission or valuation for the purpose of computing damages equivalent to rescission.

That the elements of a private cause of action under the general antifraud provisions permit customers to obtain rescissory relief for implied advisory misrepresentations is not surprising, since a customer presumably attaches importance to a broker-dealer's implied advisory representations in selecting particular securities to purchase or sell. However, in the case of implied commercial misrepresentations, where a customer cannot reasonably attach importance to a broker-dealer's implied representations in selecting particular securities to purchase or sell, the availability of rescissory relief for their contravention seems inappropriate.[38] Nonetheless, it is submitted that the elements of a private cause of action under the general antifraud provisions permit customers to obtain rescissory relief even for implied commercial misrepresentations.

A. *Elements of a Private Cause of Action under the General Antifraud Provisions*

A cause of action for common law deceit consists of six elements: (1) a false representation by the defendant, (2) a "fact" which is the subject of the representation, (3) knowledge of the falsity of the representation (*scienter*) on the part of the defendant, (4) materiality of the representation, (5) reliance upon the

37 *See, e.g.*, 3 Loss, at 1720-21 (§ 12(2)), 1793-94 (Rule 10b-5). Only under § 12(2), however, is a plaintiff restricted to rescissory relief.

A plaintiff who establishes the elements of a private cause of action under Rule 10b-5 or Rule 15c1-2 is entitled to rescission. Exchange Act § 29(b), 15 U.S.C. § 78cc(b) (1971). Section 29(b) provides, *inter alia*, that every contract made in violation of any provision of the Exchange Act or any rule thereunder is void "as regards the rights of any person who . . . shall have made . . . any such contract. . . ."

Similarly, a plaintiff who establishes the elements of a private cause of action for misrepresentation in a face-to-face transaction under the Federal Securities Code would be entitled to rescissory relief. See FSC §§ 1301, 1402(a). Transactions between a broker-dealer and his customers are obviously face-to-face.

38 For detailed discussion of this point see Section III *infra*.

representation by the plaintiff, and (6) a causal relationship between the defendant's representation and the loss for which the plaintiff seeks to recover.[39] Each of these elements has been widely recognized in one form or another as an element of an implied private cause of action under Section 17(a) and Rules 10b-5 and 15cl-2. The first, second, and fourth elements also are requisite to a cause of action under Section 12(2). A seventh element — privity of contract between the plaintiff and the defendant — is requisite to a cause of action under Section 12(2) but probably not to an implied private cause of action under the other general antifraud provisions. These seven elements[40] will be examined in order to ascertain whether any of them necessarily prevents a customer from obtaining rescissory relief for an implied commercial representation by his broker-dealer.

The shingle theory itself enables a customer to satisfy the first two of these seven elements. The requisite representation[41] is

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39 *See* 3 Loss, at 1431.

40 There are, of course, three other "elements" which a private plaintiff must establish in order to recover under the general antifraud provisions: (1) the misrepresentation must have been made at least "in connection with" a securities transaction; (2) the defendant must have utilized one or more of the federal jurisdictional instrumentalities; and (3) the plaintiff must have complied with the applicable statute of limitations. *See generally* 3 Loss. Obviously none of these requirements necessarily prevents a customer from obtaining rescissory relief for an implied commercial misrepresentation.

41 An affirmative representation is not always required. Under certain circumstances corporate insiders and their tippees have a special obligation to disclose material nonpublic facts of which they are aware to the persons with whom they trade. A failure to disclose such facts when disclosure is required violates the general antifraud provisions. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907 (1961). The failure to disclose, moreover, satisfies the "false representation" element of a private cause of action. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 461-62 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (dictum).

The distinction between an insider's failure to disclose when disclosure is required and a broker-dealer's implied misrepresentation is purely theoretical. Indeed, courts sometimes characterize the former as an implied misrepresentation and the latter as a failure to disclose. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951), *aff'd as modified*, 235 F.2d 369 (3rd Cir. 1956) (on other grounds) (insider's failure to disclose characterized as implied misrepresentation); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (broker-dealer's implied misrepresentation characterized as failure to disclose). In reality, the obligations of an insider and a broker-dealer are similar. Underlying the formalism of the shingle theory is a simple principle: a broker-dealer, like an insider, has a special quasi-fiduciary obligation to disclose certain material facts under certain cir-directly implied by virtue of the theory. A customer can also employ the shingle theory to fulfill the requirement that the subject of the representation be a "fact." An implied representation, unlike an express representation, is not made at any discrete moment. Speaking technically, therefore, a broker-dealer never impliedly represents that he will not engage in a specific unfair or unprofessional practice, but rather continuously represents impliedly that he is not engaging in the practice.[42] Hence the implied representation relates to a fact, not merely to an intention.

The privity of contract element is no obstacle to a customer seeking rescissory relief for an implied commercial misrepresentation. Section 12(2) requires a special form of privity: the defendant must be the plaintiff purchaser's immediate seller. Since a broker does not "sell" in the sense of passing title, this requirement might seem to exempt from liability a broker-dealer who acts as a broker rather than a dealer in the particular sale. But a broker has been held to sell within the meaning of Section 12(2) whether he represents a purchaser whose order he solicited,[43] a seller,[44] or both.[45] The privity requirement of Section 12(2), therefore, does not prevent a customer from suing his broker-dealer under that provision for an implied commercial misrepresentation.

While there is precedent for requiring a "semblance of privity" in private actions under the other general antifraud provisions,[46] the overwhelming weight of recent authority is to the contrary.[47]

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cumstances. An implied broker-dealer misrepresentation consists essentially of a failure to disclose such facts when disclosure is required.

42 For the sake of simplicity, however, some implied broker-dealer representations are phrased herein in the future tense.

43 Murphy v. Cady, 30 F. Supp. 466, 469 (D. Me. 1939), *aff'd without consideration of the point,* 113 F.2d 988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).

44 Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).

45 *Id.* For a more detailed discussion of the applicability of § 12(2) to brokers see 3 Loss, at 1713-15; 6 *id.* at 3834-36.

46 *See* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd per curiam,* 198 F.2d 883 (2d Cir. 1952) (Rule 10b-5).

47 *See, e.g.,* Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 249 (6th Cir. 1962); Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548, 558 (D. Utah 1970), *aff'd in part and rev'd in part sub nom.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101-02 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

Even if privity were required, however, the holdings under Section 12(2) that a broker as well as a dealer may be liable to his customer would seem to extend a fortiori to private actions under Section 17(a) and Rules 10b-5 and 15cl-2.

The next element is *scienter* on the part of the defendant. *Scienter*

> has been variously defined to mean everything from knowing falsity with an implication of *mens rea,* through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault . . . .[48]

It consists essentially of some form of knowledge of the falsity of the representation in question or, in other words, of something more than mere negligence.

The absence of *scienter* does not under current law prevent a customer from obtaining recissory relief for an implied commercial misrepresentation. *Scienter* is not an element of a cause of action under Section 12(2).[49] On the other hand, Rule 15cl-2(b) expressly requires proof of *scienter,* and there is considerable controversy as to whether proof of *scienter* is required in private actions under Rule 10b-5. However, after a careful analysis of the relevant decisions, one commentator recently concluded that no appellate court had ever imposed liability for mere negligence in a private action under Rule 10b-5.[50]

In lieu of a privity requirement, federal courts usually insist, at least in actions for damages, that the plaintiff himself be a purchaser or seller of securities. *See, e.g.,* Greater Iowa Corp. v. McLendon, 378 F.2d 783, 791-92 (8th Cir. 1967); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952); Greenstein v. Paul, 275 F. Supp. 604 (S.D.N.Y. 1967), *aff'd* 400 F.2d 580 (2d Cir. 1968). *See also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975). This prerequisite obviously does not impair the ability of a customer to sue his broker-dealer for an implied commercial misrepresentation.

48 3 Loss, at 1432.

49 Ellis v. Carter, 291 F.2d 270, 272 (9th Cir. 1961) (dictum); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 767-68 (D. Colo. 1964) (dictum). Mere negligence is sufficient and the defendant bears the burden of proof. Globus v. Law Research Serv., Inc., 287 F. Supp. 188, 198 (S.D.N.Y. 1968) (dictum), *aff'd in part, rev'd in part without consideration of the point,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

Nor is *scienter* an element of a private cause of action for misrepresentation under the Federal Securities Code. As under § 12(2), the test is negligence and the defendant bears the burden of proof. *See* FSC §§ 1301, 1402; ALI Fed. Sec. Code §§ 1402(a)-(c), Comment 1 (Tent. Draft No. 2, 1973).

50 Bucklo, *Scienter and Rule 10b-5,* 67 Nw. U.L. Rev. 562, 590 (1972). *See* Note,

Thus a customer who sold rather than purchased a security probably is required to prove *scienter* on the part of his broker-dealer in order to sue for an implied commercial misrepresentation. But there is nothing inherent in the nature of implied commercial misrepresentations which makes *scienter* more difficult to prove in such a suit than in private actions under Rule 10b-5 for ordinary express misrepresentations.

Since the general antifraud provisions prohibit only misrepresentations which relate to material facts, it must next be ascertained whether this materiality requirement precludes civil liability for implied commercial misrepresentations. As observed above, for Commission actions the Commission has held that each of the broker-dealer representations which it has identified as implied by virtue of the shingle theory relates to a material fact. In private actions, federal courts accord considerable weight to holdings by the Commission, even in unrelated proceedings.[51] They are not, however, bound by such holdings.

Under the common law a material fact "is one to whose existence or nonexistence a reasonable man would attach importance in determining his choice of action in the transaction in question."[52] Federal courts have adopted this objective definition as the fundamental test of materiality in private actions under the general antifraud provisions.[53]

Under this definition a broker-dealer's adherence to trade custom, for example, in performing his routine commercial functions is a material fact. In selecting particular securities to purchase or sell, a customer cannot reasonably attach importance to a broker-dealer's adherence to trade custom in performing his

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87 HARV. L. REV. 1066, 1068-1071 (1974). *But cf.* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

51 *See e.g.*, Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder], CCH FED. SEC. L. REP. ¶ 91,621 at 95,321 (S.D. Cal. 1965).

52 RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (Tent. Draft No. 10, 1964).

53 *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert denied*, 382 U.S. 811 (1965). In *Affiliated Ute Citizens*, the Supreme Court rephrased the definition of materiality in slightly more liberal terms. The Court held that facts are material if "a reasonable investor *might* have considered them important" in making his decision. 406 U.S. at 153-54 (emphasis added).

The Federal Securities Code also utilizes this definition of materiality. *See* FSC § 256(a).

routine commercial functions. However, in deciding to trade either with or through a particular broker-dealer, a customer reasonably would attach importance to such adherence. The phrase "choice of action in the transaction in question" in the common law test of materiality is sufficiently broad to encompass the choice of a broker-dealer with or through whom to trade as well as the choice of securities to purchase or sell.[54] Therefore an implied commercial representation does relate to a material fact.

The element of reliance is closely related to the element of materiality. The fundamental test of materiality — whether a reasonable man would attach importance to the fact misrepresented — is objective. The test of reliance, on the other hand, is subjective. The individual plaintiff must have attached importance to — that is, relied upon — the fact misrepresented.[55]

If a customer who sues his broker-dealer for an implied commercial misrepresentation were required to prove affirmatively his reliance upon the fact misrepresented, the requirement might be difficult to satisfy. But he is not required to do so. Reliance is not an element of a cause of action under Section 12(2).[56] Thus a customer who purchased a security can sue his broker-dealer under Section 12(2) for an implied commercial misrepresentation whether or not he relied upon the fact misrepresented.

Proof of reliance is not required, moreover, in private actions under the other general antifraud provisions in which the "misrepresentation" consists of nondisclosure of a material fact in contravention of a special obligation to disclose. In such cases reliance is presumed from the materiality of the undisclosed

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54 The Second Circuit has expressly reached the same conclusion with respect to the implied representation concerning prompt consummation. The court reasoned that "[a]ny average prudent investor would surely want to know . . . whether the entire purchase transaction will be completed reasonably promptly. It follows, therefore, that the omissions involved in this case were material." DeMarco v. Edens, 390 F.2d 836, 840-41 (2d Cir. 1968) (citations omitted) (§ 12(2) action).

55 *See* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

56 Woodward v. Wright, 266 F.2d 108, 116 (10th Cir. 1959); Emmi v. First-Mfrs. Nat'l Bank, 336 F. Supp. 629, 635 (D. Me. 1971). Section 12(2) requires only that the plaintiff not have known of the misrepresentation at the time it was made.

Nor is reliance an element of a private cause of action for misrepresentation under the Federal Securities Code. *See* FSC §§ 1301, 1402; *id.* § 215A, Comment 5 (Tent. Draft No. 2, 1973).

fact.[57] An implied broker-dealer misrepresentation consists essentially of a failure to disclose a material fact when disclosure is required.[58] A customer who sues his broker-dealer for an implied commercial misrepresentation need not prove, therefore, that he relied upon the fact misrepresented.

The final element of a private action, causation, is designed to ensure a reasonable connection between the defendant's misrepresentation and the loss for which the plaintiff seeks to recover. Under the common law of torts, a plaintiff is required to establish two distinct types of causation: causation in fact and proximate causation. A misrepresentation causes a loss in fact if it is a substantial and material factor in producing the loss.[59] On the other hand, proximate causation is a question of legal policy rather than of fact. If responsibility for a misrepresentation ought to extend to a particular loss which it causes in fact, the misrepresentation is said proximately to cause the loss.[60]

As will be demonstrated below, rescissory relief compensates a customer for losses which implied commercial misrepresentations generally do not cause either proximately or even in fact. If a customer were required to establish either proximate causation or causation in fact, therefore, he could seldom obtain rescissory relief for an implied commercial misrepresentation. But under present law a customer who sues his broker-dealer for an implied commercial misrepresentation need not establish either type of causation.

Causation, like reliance, is not an element of a cause of action under Section 12(2).[61] Nor is a plaintiff required to establish

57 *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154 (1972); *cf.* Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569, 575 (2d Cir. 1970); Kahan v. Rosenstiel, 424 F.2d 161, 173-74 (2d Cir.), *cert. denied*, 398 U.S. 950 (1970); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,714, at 93,168 (S.D.N.Y. 1972); *cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970) (class action derivative suit under Exchange Act § 14(a) for violation of proxy rules). *See* Note, 86 HARV. L. REV. 268-72 (1972).

58 *See* note 41 *supra*.

59 *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 41, at 240 (4th ed. 1971).

60 *See id.* § 42, at 244.

61 *See* Emmi v. First-Mfrs. Nat'l Bank, 336 F. Supp. 629, 635 (D. Me. 1971); Newberg v. American Dryer Corp., 195 F. Supp. 345, 352 (E.D. Pa. 1961).

Nor is the plaintiff required to prove either type of causation required in a causation in private actions under the other general antifraud provisions in which the "misrepresentation" consists of nondisclosure of a material fact in contravention of a special obligation to disclose. In express misrepresentation cases under these provisions, a plaintiff must at least establish causation in fact, and it is unclear whether causation in fact is sufficient.[62] Nevertheless, in nondisclosure cases, a plaintiff need not establish even causation in fact: although it is theoretically an element of a private cause of action in such cases, causation in fact is conclusively presumed from the materiality of the undisclosed fact.[63] Since an implied broker-dealer misrepresentation is tantamount to a failure to disclose,[64] a customer who sues his broker-dealer for an implied commercial misrepresentation is not required to establish a causal relationship between the misrepresentation and the loss for which he seeks to recover.

B. *Private Actions for Implied Commercial Misrepresentations*

The number of reported suits by customers against their broker-dealers is insignificant as compared to the number of administrative proceedings against broker-dealers.[65] Moreover, private actions for implied commercial misrepresentation have comprised only a small proportion of these suits. But the private actions for implied commercial misrepresentations which have been reported tend on the whole to confirm the availability of rescissory relief for such misrepresentations.

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private action under the Federal Securities Code for misrepresentation in a face-to-face transaction. *See* FSC §§ 1301, 1402(a); ALI Fed. Sec. Code § 1402(f)(2), Comment 1 (Tent. Draft No. 2, 1973). Transactions between a broker-dealer and his customers are obviously face-to-face.

62 2 A. BROMBERG, SECURITIES LAW FRAUD § 8.7(1), at 213-214 (1973).

63 *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,714, at 93, 168-69 (S.D.N.Y. 1972); *cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970) (class action derivative suit under Exchange Act § 14(a) for violation of proxy rules).

These holdings do not differentiate causation of the particular loss for which the plaintiff seeks to recover from causation of the transaction in which the loss is incurred. A leading commentator has observed that the element of causation "is not yet developed to the base point of distinguishing between causation of the transaction and causation of the economic loss." 2 A. BROMBERG, *supra* note 62, § 8.7(2), at 215-16.

64 *See* note 41 *supra.*

65 1 A. BROMBERG, *supra* note 62, § 5.5, at 101.

There has been at most one private action for contravention of the implied representation concerning reasonable markups, and its value as a precedent is doubtful.[66] An analogous case, however, intimates that a customer can obtain rescissory relief for contravention of this implied representation. In *Chasins v. Smith, Barney & Co.*,[67] a broker-dealer sold securities to a customer without disclosing that he[68] was making an over-the-counter market in the securities. The district court granted the customer rescissory relief.[69] The court analyzed the broker-dealer's failure to disclose his market-maker status as if it constituted an implied commercial misrepresentation. Under the court's theory, a broker-dealer's status as a market-maker is material in that it may affect the price which the customer pays for the securities. The court held:

> Such information was material to the plaintiff in considering the price at which he purchased the securities, and to what extent the price was based on defendant's own market activities.[70]

In other words, the fact that a broker-dealer is making a market in the securities which he sells to a customer suggests that his markup may be excessive. A reasonable customer therefore would attach importance to this fact in deciding whether to purchase the securities from the particular broker-dealer.

In affirming the district court's judgment, the Second Circuit

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66 Gorsuch v. Bangert, [1948-1952 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,537 (E.D. Pa. 1952), discussed in 3 Loss, at 1487 n.38. It is unclear whether the representation concerning the defendant's markup was express or implied. In any event, the court applied a state rather than a federal measure of damages.

67 305 F. Supp. 489 (S.D.N.Y. 1969), *motion to amend denied*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970). Neither in *Chasins* nor in the other private actions for implied misrepresentations to be discussed is the shingle theory cited by name. In fact, federal courts have cited the shingle theory by name only three times, once in a concurring opinion and twice in footnotes. Hanley v. SEC, 415 F.2d 589, 596, n.12 (2nd Cir. 1969); Kahn v. SEC, 297 F.2d 112, 115 (2nd Cir. 1961) (Clark, J., concurring); Vernon J. Rockler & Co. v. Graphic Enterprises, Inc., 52 F.R.D. 335, 342 n.12 (D. Minn. 1971). It is clear, nonetheless, that in each of the cases to be discussed the court tacitly (and perhaps even unwittingly) applied the shingle theory.

68 For the sake of semantic consistency, a corporate broker-dealer as well as an individual broker-dealer is referred to herein as "he."

69 305 F. Supp. at 496-97; 306 F. Supp. at 178-79.

70 305 F. Supp. at 495. *See* 305 F. Supp. at 496; 306 F. Supp. at 178 (similar language).

analyzed the broker-dealer's failure to disclose his market-maker status as if it constituted an implied advisory misrepresentation. Under its theory, a broker-dealer has a special interest in selling securities in which he makes a market, and this interest may influence his recommendations to purchase the securities. Therefore, according to the Second Circuit's view, a reasonable customer would attach importance to this interest in deciding whether to purchase the particular securities recommended.[71] In adopting this analysis, the Second Circuit did not review the district court's theory. Thus the district court's decision remains a precedent for the granting of recissory relief for an implied commercial misrepresentation. It strongly suggests that a customer can, under present law, obtain such relief for contravention of the implied representation concerning reasonable markups.

Besides markup, a broker-dealer also has been held liable in one private action for contravention of his implied representation of solvency.[72] But the broker-dealer in that case contravened several other implied representations as well, including the one concerning misappropriation.[73] Thus the granting of rescissory relief (against an aider and abettor) in this action does not definitively establish the availability of such relief for contravention of the implied representation of solvency.

The authorities are divided as to whether a customer can obtain rescissory relief for contravention of the implied representation concerning churning. In churning cases rescission itself is impractical.[74] Rescissory relief therefore consists of damages computed in accordance with an out-of-pocket measure which compensates a customer for his market losses by awarding him the difference between the amount of his original investment (or the initial market value of his portfolio) and the amount returned to him (or the final market value of his portfolio).[75] A state court has applied the out-of-pocket measure of damages in a common

71 438 F.2d at 1170-73. Judge Friendly, in his dissenting opinion, specifically criticized this aspect of the majority's view. 438 F.2d at 1176.

72 Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

73 *Id.* at 705-08.

74 *See* Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 883 n.117 (1967); Comment, *Private Actions for "Churning,"* 40 MO. L. REV. 281 (1975).

75 *See* Note, *supra* note 74, at 884.

law action for churning.[76] Several commentators, moreover, have suggested the use of this measure in federal churning cases.[77]

In each of the three private actions under the general antifraud provisions for churning which have reached final judgment, however, the court declined to apply the out-of-pocket measure. The principal reason for declining to apply this measure was the same in each case: churning per se does not proximately cause a customer's market losses.[78] All three of these decisions, however, antedated *Affiliated Ute Citizens v. United States,*[79] in which the Supreme Court held that causation need not be established in nondisclosure cases.[80] Thus there is reason to believe that today each of the three cases would be decided differently.

There have been at least two private actions for contravention of the implied representation concerning prompt execution. In *Opper v. Hancock Securities Corp.,*[81] a broker-dealer unreasonably delayed executing a sell order, and the customer ultimately had another broker-dealer execute it. In *Bird v. Ferry,*[82] a broker-dealer consistently failed to execute purchase and sell orders and instead misappropriated the funds and securities which his customer entrusted to him. In each case the customer obtained damages computed in accordance with a loss-of-bargain measure.[83]

76 Pierce v. Richard Ellis & Co., 62 Misc. 2d 771, 210 N.Y.S.2d 266 (Civ. Ct. 1970). Another state court has also permitted a plaintiff to recover his market losses in a common law action involving churning. Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968). But the *Twomey* court held not only that the broker-dealer churned his customer's account but also that the securities which he purchased for the account were unsuitable. *Id.* at 727, 729-30, 732-33, 69 Cal. Rptr. at 247, 249-51. Thus this case is not a precedent for the granting of rescissory relief for churning per se.

77 *See* 6 Loss, at 3679; Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions,* 1972 U. ILL. L.F. 651, 678. Another commentator has recommended the adoption of a loss-of-bargain measure of damages in churning cases. Note, *Churning by Securities Dealers,* 80 HARV. L. REV. 869, 886 (1967).

The Federal Securities Code would in churning cases authorize a court under certain circumstances to award damages which compensate a customer for his market losses. *See* FSC §§ 1306, 1410; *id.* § 1410, Comment 1 (Tent. Draft No. 2, 1973).

78 Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1212 (9th Cir. 1970); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 849-50 (E.D. Va. 1968) (*semble*); Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 at 95,321-22 (S.D. Cal. 1965).

79 406 U.S. 128 (1972).

80 *Id.* at 154. *See* note 63 and accompanying text *supra.*

81 250 F. Supp. 668 (S.D.N.Y.), *aff'd per curiam,* 367 F.2d 157 (2d Cir. 1966).

82 497 F.2d 112 (5th Cir. 1974).

83 *Id.* at 113; Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 676-77 (S.D.N.Y.), *aff'd per curiam,* 367 F.2d 157 (2d Cir. 1966).

Since there were no transactions to rescind, rescissory relief was infeasible. These cases do not refute, therefore, the availability of rescissory relief when such relief is feasible.

Finally, there have been several private actions under Section 12(2)[84] and Rule 10b-5[85] for concurrent contravention of the implied representations concerning prompt consummation and misappropriation. In each of the cases cited the customer obtained rescissory relief.[86]

In short, the private actions for implied commercial misrepresentations which have been reported tend, on the whole, to confirm the availability of rescissory relief for such misrepresentations.

C. *Implied Commercial Misrepresentations under the Federal Securities Code*

Like the elements of a private cause of action under the general antifraud provisions, the elements of a private cause of action for misrepresentation under the proposed Federal Securities Code would permit a customer to obtain rescissory relief for an implied commercial misrepresentation.[87] It remains to be determined whether any related provision of the Code would prevent this recovery.

There is only one Code provision which conceivably could

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84 DeMarco v. Edens, 390 F.2d 836 (2d Cir. 1968); Guardian Inv. Corp. v. Rubinstein, 192 A.2d 296 (D.C. App. 1963).

85 Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949).

86 DeMarco v. Edens, 390 F.2d 836 (2d Cir. 1968); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 729 (N.D. Ind. 1968), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 124-25 (W.D. Ark. 1949); Guardian Inv. Corp. v. Rubinstein, 192 A.2d 296, 298 (D.C. Ct. App. 1963).

87 *See* notes 37, 49, 56, 61 *supra.* This conclusion is, of course, based upon the assumption that plaintiffs would be able to utilize the shingle theory in private actions under the Federal Securities Code for misrepresentation. The draftsmen of the Code have indicated that they intend to "codify" the shingle theory. *See* ALI Fed. Sec. Code § 1423(a), Comment 2 (Tent. Draft No. 2, 1973). It is unclear whether the codification which they envision would render the shingle theory unavailable in private actions for misrepresentation. As the Code is presently drafted, moreover, there is no provision which would preclude plaintiffs from utilizing the shingle theory in private actions. In the absence of any such provision, the shingle theory would presumably be available to private plaintiffs.

prevent a customer from obtaining rescissory relief for an implied commercial misrepresentation. Section 1418(f) provides:

> [T]he measure of damages and definition of rescission . . . may be varied on a showing that a different measure of damages or definition of rescission would be plainly more appropriate on consideration of such factors as the plaintiff's loss, the defendant's profit, and the deterrent effect of the particular type of liability.

Yet this provision is unlikely to prevent a customer from obtaining rescissory relief for such a misrepresentation. In the first place, it is unclear whether the authority which this provision would confer upon courts to "vary" the definition of rescission includes the authority to deny rescission altogether. Secondly, and more significantly, neither the language of Section 1418(f), nor the official comments thereto,[88] suggests that the provision is intended to empower a court to introduce a causation requirement in private actions under Section 1402(a). The draftsmen of the Code deliberately excluded causation as an element of a cause of action under Section 1402(a).[89] It is the absence of a causation requirement in private actions under Section 1402(a), just as under the general antifraud provisions, which would permit a customer to obtain rescissory relief for an implied commercial misrepresentation.

Finally, even if Section 1418(f) were construed as authorizing a court to deny rescissory relief for implied commercial misrepresentations, it is not clear that courts would exercise this authority. Although courts presumably have some discretion in fashioning relief in private actions under the existing general antifraud provisions,[90] they have not, as previously indicated, exercised this discretion to deny rescissory relief for implied commercial misrepresentations.

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88 ALI Fed. Sec. Code § 1417(f), Comments 1-3 (Tent. Draft No. 2, 1973).

89 *Compare* FSC § 1402(a) *with* § 1402(f)(2).

90 *See* 3 Loss, at 1794-96; 6 *id.* at 3923-25; Note, *Measurement of Damages in Private Actions under Rule 10b-5*, 1968 WASH. U.L.Q. 165, 179. While courts presumably have some discretion in fashioning relief in private actions under § 17(a) and Rules 10b-5 and 15cl-2, they have little if any such discretion in actions under § 12(2).

III. The Propriety of Rescissory Relief for Implied Broker-Dealer Misrepresentations

The preceding analysis indicates that a customer who proves an implied misrepresentation by his broker-dealer can obtain rescissory relief under present law. Such relief for implied advisory misrepresentations is not inherently improper. Since a customer presumably attaches importance to a broker-dealer's implied advisory representations in selecting particular securities to purchase or sell, rescissory relief for their contravention is in principle as proper as rescissory relief for ordinary express misrepresentations concerning an issuer.

The propriety of rescissory relief for implied commercial misrepresentations is a different matter. As noted above, rescissory relief compensates a customer for his market losses — decreases (or increases) in the market value of the securities which the customer purchased (or sold) between the date of the transaction and the date of recission or valuation for the purpose of computing damages equivalent to rescission. Since a customer cannot, in selecting particular securities to purchase or sell, reasonably attach importance to a broker-dealer's implied commercial representations, the propriety of rescissory relief for their contravention is unclear. Such relief is proper if, but only if, it is justified by one or more of the policies which underlie civil liability under the general antifraud provisions: the prevention of unjust enrichment, compensation, and deterrence.[91] Whether any of these three policies justifies rescissory relief for implied commercial misrepresentations is doubtful.

Most implied commercial misrepresentations unjustly enrich a broker-dealer. The policy against unjust enrichment, however, justifies rescissory relief for such misrepresentations only to the extent that such misrepresentations unjustly enrich him by an

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91 *See, e.g.*, Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965) (Rule 10b-5 requires disgorgement of unjust enrichment); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 253 (1933) (policies underlying Securities Act civil liabilities are compensation and deterrence).

amount equal to the amount of the market losses for which rescissory relief compensates a customer.

No implied commercial misrepresentation unjustly enriches a broker-dealer by this amount. Markups or markdowns which are unreasonably related to the prevailing market price of the securities sold or purchased unjustly enrich a broker-dealer by the amount of the excess markup or markdown. Churning unjustly enriches him by the amount of the commissions which he earns from the excess trading. Late delivery of securities unjustly enriches him by the amount of any dividends or interest payments which he receives as holder of the securities; late delivery of sale proceeds, by the amount of interest which he should have paid for the use of his customer's funds. Misappropriation unjustly enriches him by the amount of the misappropriated funds or the market value of the misappropriated securities at the time of misappropriation.[92] Contravention of the implied representation of solvency or the implied representation concerning prompt execution does not enrich a broker-dealer at all.

None of these implied commercial misrepresentations, therefore, unjustly enriches a broker-dealer by an amount equal to the amount of the market losses for which rescissory relief compensates a customer. Thus the policy against unjust enrichment does not justify full rescissory relief for such misrepresentations.

The policy in favor of compensation is limited to the compensation of losses which are caused by the defendant's conduct.[93] The compensation policy, therefore, justifies rescissory relief for implied commercial misrepresentations only to the extent that

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92 A strong argument can be made that the misappropriation of securities unjustly enriches a broker-dealer not only by the market value of the securities at the time of misappropriation but also by any subsequent increases in the market value of the securities. But rescissory relief for the misappropriation of securities (assuming the existence of a transaction to rescind) consists of the purchase price of the securities, not of the market value of the securities at some subsequent time. Even if this argument were accepted, therefore, the policy against unjust enrichment would not justify rescissory relief for the misappropriation of securities.

93 *See, e.g.*, W. PROSSER, *supra* note 59, § 1, at 6; Wright, *Introduction to the Law of Torts*, 8 CAMB. L.J. 238 (1944). There is no reason to suppose that the policy in favor of compensation which underlies civil liability under the general antifraud provisions differs from the compensation policy which underlies the common law of torts.

such misrepresentations cause the market losses for which rescissory relief compensates a customer.

Implied commercial misrepresentations do not inherently cause, even in fact, the market losses which a customer sustains. As indicated above, a customer presumably attaches importance to implied commercial representations in deciding to trade either with or through a particular broker-dealer. If the customer knew that one of these representations was false, he would presumably decide not to patronize the particular broker-dealer. But a customer cannot reasonably attach importance to implied commercial representations in selecting particular securities to trade. Consequently, knowledge of the falsity of one of these representations would not affect the customer's determination to trade the particular securities which he originally selected. He presumably would trade the same securities, although with or through a different broker-dealer.

Thus unreasonable markups or markdowns, late execution of purchase orders, late delivery of sale proceeds, misappropriation of funds, and contravention of the implied representation of solvency cannot cause market losses in fact. However, the possibility that the other implied commercial misrepresentations previously enumerated may cause market losses requires further analysis.

Several courts and commentators have suggested that churning can cause market losses.[94] It is submitted that these authorities

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94 *See* Fey v. Walston & Co., 493 F.2d 1036, 1054-55 (7th Cir. 1974) (dictum); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 440 (N.D. Cal. 1968), *modified and aff'd,* 430 F.2d 1202 (9th Cir. 1970); Cobine, *supra* note 77, at 681-82; Note, *Churning by Securities Dealers,* 80 HARV. L. REV. 869, 883-84 (1967). In *Fey,* the Seventh Circuit suggested that churning can cause market losses. However, it reversed the district court's judgment (which compensated the customer for her market losses) on the ground, *inter alia,* that some of the losses resulted from transactions which the customer independently initiated. 493 F.2d at 1055.

The district court in *Hecht* held that churning proximately caused the customer's market losses in her commodities account. On appeal, the Ninth Circuit held that churning did not cause these losses and modified the district court's judgment by limiting recovery to commissions and interest. 430 F.2d at 1212.

The draftsmen of the Federal Securities Code apparently also believe that churning can cause market losses. They specify "trading losses caused by the violation" as an item of damages which a court might allow in churning cases. ALI Fed. Sec. Code § 1410, Comment 1 (Tent. Draft No. 2, 1973).

have confused two distinct activities — the churning of an account and the purchase of unsuitable securities for the account. Churning per se (that is, mere overtrading) need not be accompanied by the purchase of unsuitable securities. A broker-dealer can churn an account by overtrading in securities which are eminently suitable for his customer's needs. Indeed, in two of the few churning cases which have reached final judgment, the courts expressly held that the securities purchased for the account were suitable.[95]

Churning per se can never cause market losses, even in fact. While the number of "turnovers" in an account required to support a finding of churning depends upon the investment objectives and financial resources of the particular customer,[96] it seems clear that a single turnover is insufficient.[97] Accordingly, a broker-dealer may legitimately trade all of the securities in the portfolio originally entrusted to him at least once. Since the securities in the original portfolio are disposed of in the legitimate, initial trades, the subsequent churning does not cause in fact any net reduction in the market value of the portfolio. And when a broker-dealer overtrades in unsuitable securities, any market losses sustained by his customer are caused by the unsuitability of the securities purchased, not by the churning.

There are a few implied commercial misrepresentations which

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95 Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 850 (E.D. Va. 1968); Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 at 95, 322 (S.D. Cal. 1965).

96 *See, e.g.*, Sec. Ex. Act Rule 15cl-7(a), 17 C.F.R. 240.15cl-7(a) (1972); Norris & Hirshberg, Inc., 21 S.E.C. 865, 890-91 (1946), *aff'd* 177 F.2d 228 (D.C. Cir. 1949).

97 The Commission has found a broker-dealer who turned over his customer's portfolio 3.73 times guilty of churning. Richard N. Cea, 44 S.E.C. 8, 19 (1969). Apparently no smaller number of turnovers has ever been held to support a finding of churning. For surveys of the numbers of turnovers which have been held to support findings of churning, *see* Jacobs, *supra* note 17, at 933 n.362; Note, *Churning: A Critical Analysis*, 14 N.Y.L.F. 315, 323 n.56 (1968); Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869-876 (1967); Comment, *The Lack of a Definite Standard to Measure Excessive Trading Activity in Over-the-Counter Customers' Securities Accounts*, 41 TEMP. L.Q. 116, 125 (1967); 32 A.L.R. 3d 635, 645-47 (1970).

Several commentators have suggested that a single turnover can never support a finding of churning. *See* Note, *Churning: A Critical Analysis*, *supra*, at 315 (churning occurs when portfolio is turned over "time after time"); Note, *Churning by Securities Dealers*, *supra*, at 870 (finding of churning must be based upon an "extended pattern" of trading).

can cause market losses sustained by a customer. First, a customer who foresees an imminent decline in the market value of securities which he owns presumably will decide to sell the securities at once. But a customer is unable to sell securities which have not yet been delivered to him or to his account. Thus when a broker-dealer unreasonably delays delivery of securities purchased by his customer, he prevents his customer from selling the securities and may thereby cause any market loss which the customer sustains prior to delivery. A fortiori, a broker-dealer who misappropriates securities purchased by his customer may cause any market loss which his customer subsequently sustains. In each case, whether the customer actually would have sold the securities in time to avert the loss is a question of fact. If this question ultimately is resolved in the customer's favor either by proof or by presumption, any market loss which he sustained logically can be attributed to the broker-dealer's conduct. Contravention of the implied representations concerning prompt consummation and misappropriation can, therefore, cause market losses in certain rare situations.

Thus the policy in favor of compensation justifies rescissory relief only for the two implied commercial misrepresentations specified above. The other implied commercial misrepresentations, with one further arguable exception,[98] cannot cause market losses — thus, the compensation policy does not justify rescissory relief for them.

Relief which is justified neither by the policy against unjust enrichment nor by the policy in favor of compensation may be justified nevertheless by the policy of deterrence. A broker-dealer's knowledge of the possibility of civil liability for an amount far in excess of the amount either of his unjust enrichment from his misconduct or of the losses caused by his misconduct would tend to deter such misconduct. It is submitted, however, that rescissory

98 Contravention of the implied representation concerning prompt execution can also cause market losses. Late execution of a sale order causes any market loss sustained by the customer during the period in which execution is unreasonably delayed. But rescissory relief for contravention of the implied representation concerning prompt execution is not feasible since there is no transaction to rescind. Courts therefore apply a loss-of-bargain measure of damages. *See* note 83 and accompanying text *supra*.

relief is both unnecessary and inappropriate as a deterrent against implied commercial misrepresentations because other effective deterrents exist.

First, a broker-dealer who violates the general antifraud provisions by contravening one of his implied commercial representations is subject to a formidable array of public sanctions. The Commission can sue for an injunction against further violations by the broker-dealer[99] and can suspend or expel him from the NASD[100] and all national securities exchanges.[101] If the violation was willful, it can censure the broker-dealer, or suspend or revoke his registration,[102] and can refer its findings to the Attorney General for possible criminal prosecution.[103]

Another effective deterrent against implied commercial misrepresentations is the unfavorable publicity which an administrative or judicial determination that a broker-dealer violated the general antifraud provisions usually generates.[104] Such publicity may impair a broker-dealer's ability to attract customers and thereby injure him financially. One court has suggested that unfavorable publicity may by itself constitute a sufficient deterrent against repeated misconduct by a broker-dealer.[105]

Finally, damages limited to the amount either of a broker-dealer's unjust enrichment from his implied commercial misrepresentations or of the losses caused by such misrepresentations, whichever is greater, would both deprive him of any incentive to commit such misrepresentations and, to the extent that the losses caused by such misrepresentations exceed the amount of his unjust enrichment, deter such misrepresentations.[106]

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99 Sec. Act § 20(b), 15 U.S.C. § 77t(b) (1970); Sec. Ex. Act. § 21(e), 15 U.S.C. § 78u(e) (1970).

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

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

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

103 Sec. Act § 20(b), 15 U.S.C. § 77t(b) (1970); Sec. Ex. Act § 21(e), 15 U.S.C. § 78u(e) (1970).

104 *See* Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 848 (E.D. Va. 1968); *cf.* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1285 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). The *Globus* court observed that in the securities industry "a good name is worth more than a crown." 418 F.2d at 1285.

105 Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 848 (E.D. Va. 1968).

106 *See* Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 at 95,321 (S.D. Cal. 1965).

Not only is rescissory relief unnecessary as a deterrent against such misrepresentations, but it also is an inappropriate deterrent. Penalties for illegal conduct which are justified solely by the policy of deterrence generally are graduated in accordance with the degree of moral culpability which the particular conduct involves. This holds both for criminal sanctions and also for punitive damages, which are unavailable in private actions under the general antifraud provisions.[107] Moreover, the Commission presumably assesses the moral culpability of each broker-dealer who violates the general antifraud provisions in determining which of its disciplinary powers to exercise. But the amount of the market losses for which rescissory relief compensates a customer is unrelated to the degree of the broker-dealer's moral culpability. Since the amount of the market losses which a customer sustains is entirely fortuitous, rescissory relief is inappropriate as well as unnecessary as a deterrent against implied commercial misrepresentations.

IV. A Codification Proposal

It has been established that, with the exceptions noted in the discussion of the policy in favor of compensation, none of the three policies which underlie civil liability under the general antifraud provisions justifies rescissory relief for implied commercial misrepresentations.

Yet under the Federal Securities Code, as it is presently drafted, a customer would be able in a private action for misrepresentation to obtain rescissory relief for an implied commercial misrepresentation.[108] The customer would sue under Sections 1301 and 1402, which jointly comprise the Code's general antifraud provision.[109] The draftsmen of the Code should,

107 *See, e.g.,* DeHaas v. Empire Petroleum Co., 435 F.2d 1223, 1232 (10th Cir. 1970) (punitive damages unavailable in private actions under Rule 10b-5); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1286-87 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970) (punitive damages unavailable in private actions under § 17(a)).

108 *See* note 87 and text accompanying notes 87-90 *supra.*

109 Section 1301 would prohibit fraudulent acts or misrepresentations in connection with, *inter alia,* the purchase or sale of securities. Section 1402 would subject a person who violates § 1301 to civil liability.

therefore, eliminate civil liability under Sections 1301 and 1402 for implied commercial misrepresentations.

The following codification proposal would, if implemented, accomplish this fundamental objective in three interdependent steps. It would not, on the other hand, relieve a broker-dealer of all accountability to his customers and the Commission for his unfair or unprofessional commercial practices and any unjust enrichment caused thereby.

The first step is to "codify" a broker-dealer's implied commercial representations outside of Section 1301. Each of the specific practices which have been held to contravene such representations would be expressly prohibited by a separate provision. For example, one provision would forbid unreasonable markups.

> Section 901(a)(1)
> **No dealer shall sell securities to a customer at a price not reasonably related to the prevailing market price of such securities.**

The particularity with which each proscribed practice would be defined would depend, of course, upon the extent to which the the Commission and the courts have defined the practice. But the Commission should be authorized further to define each practice by rule.

A residual prohibitory provision would be included to complement the provisions prohibiting specific practices. This provision would forbid any broker-dealer practice which the Commission determines by rule to be either unfair or contrary to professional standards. Such a provision is required in order not to forestall the identification by the Commission of additional unfair or unprofessional commercial practices. A residual provision would obviate the need for supplementary legislation to deal with such practices.

> Section 901(b)
> **No broker or dealer shall engage in any practice which the Commission shall have determined by rule to be unfair to the customers of a broker or dealer or contrary to the standards of the profession of a broker or dealer.**

These prohibitory provisions would be incorporated in Part IX (Market Regulation) of the Federal Securities Code. Whether the provisions are incorporated in Part IX or in Part XIII

(Deceptive and Manipulative Acts) is admittedly of little practical significance.[110] The draftsmen of the Code have indicated that they intend to "codify" the shingle theory in Part IX.[111] Their choice seems justified, at least with respect to the commercial representations implied by virtue of the shingle theory. Most of the specific practices which have been held to contravene such representations are not intrinsically fraudulent.

The second step is to expressly eliminate civil liability under Sections 1301 and 1402 for implied commercial misrepresentations, using two complementary exemptive provisions. The first would accompany the prohibitory provisions in Part IX. It would provide that conduct which violates the prohibitory provisions shall not be deemed also to violate Section 1301.[112]

> **Section 901(c)**
> **Conduct by a broker or dealer which violates section 901(a) or 901(b) shall not be deemed also to violate section 1301.**

Standing alone, this exemptive provision is insufficient to eliminate completely civil liability under Sections 1301 and 1402 for implied commercial misrepresentations. It would not prevent a court, in a private action under Section 1301 and 1402, from holding a broker-dealer civilly liable for a theretofore unidentified implied commercial misrepresentation — in other words, for an unfair or unprofessional commercial practice to which the prohibitory provisions in Part IX did not yet extend. Another exemptive provision is required in order to preclude the imposition of such civil liability. This provision, which would be incorporated within Section 1301, would partially abrogate the shingle theory. It would provide that a broker-dealer shall not be deemed, by virtue of his profession, to make any implied

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110 Section 1517 would permit a court to impose more severe criminal penalties for intentional or reckless violations of Part XIII provisions than for intentional or reckless violations of Part IX provisions. *Compare* FSC § 1517(a) *with* FSC § 1517(b). This distinction represents the only practical consequence of incorporating prohibitory provisions in Part IX rather than in Part XIII.

111 *See* ALI Fed. Sec. Code § 1423(a), Comment 1 (Tent. Draft No. 2, 1973).

112 Such a provision would prevent a court from holding conduct which violates the prohibitory provisions to constitute either an implied "misrepresentation" or a "fraudulent act" within the meaning of § 1301(a). The possibility that a court might otherwise hold prohibited commercial practices to constitute fraudulent acts as well as implied misrepresentations should not be overlooked.

representation which relates neither to particular securities nor to his recommendations with respect to particular securities. Since this provision would abrogate implied commercial representations, there could be no civil liability under Section 1402 for their contravention.

> **Section 1301(e)**
> **No broker or dealer shall be deemed to make, by virtue of his profession, any implied representation unless such representation relates to particular securities or to the recommendations of the broker or dealer with respect to particular securities.**

The third step is to incorporate within Part XIV (Civil Liability) of the Code a provision which would expressly subject a broker-dealer to civil liability for violations of the prohibitory provisions in Part IX. This provision would render a broker-dealer who violates one or more of the prohibitory provisions civilly liable for the amount either of his unjust enrichment from the violation or of the losses caused by the violation, whichever is greater. Under no circumstances would this provision entitle a plaintiff to rescind.[113]

> **Section 1425**
> **A broker or dealer who violates section 901(a) or 901(b) is liable to his customer in an action to recover the amount of the broker's or dealer's unjust enrichment from the violation or the amount of the losses caused by the violation, whichever is greater.**

In this manner, the foregoing codification proposal would limit the availability of rescissory relief for implied commercial misrepresentations without relieving a broker-dealer of accountability for his unfair or unprofessional commercial practices.

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113 Under the Code's definition of "caused," "A loss is 'caused' by specific conduct to the extent that the conduct (a) was a substantial factor in producing the loss and (b) might reasonably have been expected to result in loss of the kind suffered." FSC § 215A. Causation in fact is thus an absolute prerequisite.

The proposed measure of damages would adequately compensate a customer even in the exceptional situations in which rescissory relief for an implied commercial misrepresentation is justified. As noted in the discussion of the policy in favor of compensation, rescissory relief may be justified in such situations if the implied commercial misrepresentation *causes* any market loss which the customer sustains. The proposed measure of damages would therefore compensate a customer for his market loss in these situations.

Two questions remain to be considered. The first concerns the proper disposition of the present Code provisions concerning churning. Section 1306 prohibits churning; Section 1410 subjects a broker-dealer who violates Section 1306 to civil liability. Because churning contravenes an implied commercial representation, the foregoing proposal would supersede both Sections 1306 and 1410. One of the proposed Part IX provisions would prohibit churning, and the proposed Part XIV provision would subject a broker-dealer to civil liability for churning as well as for other prohibited commercial practices. Since it is of little practical significance whether a prohibitory provision is placed in Part IX or in Part XIII,[114] however, the retention of Section 1306 would not affect the viability of the proposal.

If the draftsmen of the Code decide to retain Section 1306, they would have two options with respect to civil liability for churning: to extend the application of the proposed Part XIV provision to violations of Section 1306; to retain Section 1410 as well as Section 1306. If the latter option is chosen, the draftsmen, by revising either Section 1410 itself or at least the official comments thereto, should indicate that a plaintiff's market losses are not compensable under this section.

The remaining question is the proper treatment of implied advisory misrepresentations. The foregoing proposal would not eliminate civil liability under Sections 1301 and 1402 for such misrepresentations. As observed above, rescissory relief for implied advisory misrepresentations is not inherently improper. Since a customer presumably attaches importance to his broker-dealer's implied advisory representations in selecting particular securities to purchase or sell, rescissory relief for their contravention is in principle as proper as rescissory relief for ordinary express misrepresentations concerning an issuer. There is, accordingly, no compelling reason to eliminate civil liability under Sections 1301 and 1402 for implied advisory misrepresentations.[115]

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114 *See* note 110 *supra.*

115 It might well be advisable, however, for the Commission to identify and define such misrepresentations by rule. Section 1311(a) of the proposed Code would authorize the Commission to do so. *See* FSC § 1311(a); ALI Fed. Sec. Code § 1311, Comment 2 (Tent. Draft No. 2, 1973).

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MODERNIZING THE REGULATION OF THE COMMODITY FUTURES MARKETS

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Introduction

The trading of commodities futures on the nation's commodity exchanges forms an essential part of the system by which agricultural and other products make their way to American consumers. In recent years, the nation's commodities futures markets have seen sharp increases in trading, with total trading in 1974 reaching $571 billion.[1] Trading volume in commodity futures regulated by the Commodity Exchange Authority doubled over the last five years, while the trading value of so-called non-regulated commodity futures almost quadrupled.[2] The list of commodities traded on futures markets has expanded rapidly to include, in addition to agricultural products, such items as propane gas, housing mortgages, and precious metals. During this period, conditions on the commodities futures exchanges have been characterized by widely swinging prices, and in 1971-73, a series of events led to sharp increases in food prices which, in turn, focused public attention on the commodities futures markets.[3]

The substantial increase in trading volume and prices of commodity futures has made it possible for speculators to make

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1 Address by William T. Bagley, Chairman of the Commodity Futures Trading Commission before the National Press Club, Washington, D. C. August 5, 1975, at 1 (on file at the Commission).

2 *See* Johnson, *The Changing Face of Commodity Regulation*, 20 PRAC. LAW., 37 (1974).

3 The events which lay behind the 1971-73 price rises included the Russian wheat deal, crop difficulties in Africa and Asia, inadequate catches by the Peruvian fishing industry, and poor harvests in the United States.

extraordinary profits in a very short period.[4] Futures trading has attracted a growing number of speculators[5] and has vastly increased the already existing potential for unethical and illegal practices, resulting in failure of financial firms and losses by innocent investors.[6] At the same time, there has been a sharp decline in the prices and trading volume of the securities markets regulated by the Securities and Exchange Commission.[7]

These trends have made the futures markets increasingly important to the nation's economy and have led to increased public criticism[8] and Congressional scrutiny.[9] In response to this criticism, several bills[10] were introduced in the 93rd Congress to reform the system under which futures trading has been regulated

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4 *See* S. REP. No. 93-1131, 93d Cong., 2d Sess. 18 (1974) [hereinafter cited as SENATE REPORT].

5 *Id.*

6 Statement by President Ford on signing H.R. 13113 into law, October 24, 1974, 10 Weekly Comp. of Pres. Doc., 1366 (1974). [hereinafter cited as Statement by President Ford].

7 *See* SENATE REPORT at 19.

8 *See* Anthan, Mollenhoff & Risser, *Lax Commodity Regulation*, Des Moines Register, Feb. 18, 1973, at 1, col. 8 (first of a series of six articles). *See also* Barron's, May 28, 1973, at 11; Des Moines Register, June 5, 1973, at 1, col. 6; Wall Street Journal, June 5, 1973, at 1, col. 6; Anthan, Des Moines Register, Mar. 8, 1973, at 1, col. 3; Washington Star News, Sept. 26, 1973, at A2, col. 1; Fialka, *The Food Speculators: Pricing Policemen Found Looking the Other Way*, Washington Star News, Sept. 25, 1973, at A-1, col. 1 and A-12, col. 1; Fialka, *The Food Speculators*, Washington Star News, Sept. 23, 1973, at A-1, col. 1; Fialka, *The Food Speculators: 'Paper' Beans Soar*, Washington Star News, Sept. 4, 1973 at A-1, col. 1 and A-12 col. 2.

9 *See, e.g., Hearings on H.R. 11955 before the House Agriculture Comm.*, 93d Cong., 2d Sess. (1974); *Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess. (1974). *See generally* SUBCOMM. ON SPECIAL SMALL BUSINESS PROBLEMS OF THE HOUSE PERMANENT SELECT COMM. ON SMALL BUSINESS, SMALL BUSINESS PROBLEMS INVOLVED IN THE MARKETING OF GRAIN AND OTHER COMMODITIES, H.R. REP. No. 93-963, 93d Cong., 2d Sess. (1974); *Hearings on Review of Commodity Exchange Act and Discussion of Possible Changes Before the House Comm. on Agriculture*, 93d Cong., 1st Sess. (1973); *Hearings on Small Business Problems Involved in the Marketing of Grain and Other Commodities Before the Subcomm. on Special Small Business Problems of the House Permanent Select Comm. on Small Business*, 93d Cong., 1st Sess. (1973); *Hearings on Russian Grain Transactions Before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Operations*, 93d Cong. 1st Sess., pt. 1 (1973); *Hearings on Agriculture-Environmental and Consumer Protection Appropriations for 1974 Before a Subcomm. of the House Comm. on Appropriations*, 93d Cong., 1st Sess., pt. 4, at 386-529 (1973) [hereinafter cited as *Appropriations Hearings*].

10 H.R. 13113, 93d Cong., 2d Sess., S. 2837, 93d Cong. 2d Sess., S. 2578 93d Cong., 2d Sess. and S. 2485, 93d Cong., 2d Sess.

since 1936.[11] On October 10, 1974, Congress passed the Commodity Futures Trading Commission (CFTC) Act of 1974.[12] President Ford signed the bill into law on October 24, 1974, at Des Moines, Iowa, declaring his support for its objective of "establishing a new regulatory structure to apply to all commodity futures trading."[13] The Commodity Futures Trading Commission, the new regulatory agency charged with implementing the Act, came into being on April 21, 1975.[14]

The strong criticism leveled at regulatory agencies in general by some segments of the public and the Executive branch of the government, and the decline in public confidence in the critically important commodities industry,[15] make it appropriate to analyze this landmark legislation and the powerful independent agency that has been given regulatory responsibility.

I. Background of Futures Trading and Regulation

A. *History*

Commodity exchanges have existed in the United States since the colonial period.[16] The system of futures trading on organized commodity exchanges developed in the period 1850-1900 in response to a rapidly increasing need for centralized marketing and large-scale risk bearing in agricultural marketing.[17] This developmental period coincided with the great expansion of farm production following the introduction of railroads, the telegraph, and more efficient farm equipment. Starting in the 1930's futures markets evolved from primarily agricultural markets to public investment institutions.[18]

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11 Commodity Exchange Act, 7 U.S.C. §§ 1-17b (1970).

12 Pub. L. No. 93-463, 88 Stat. 1389. Certain time deadlines in the Act were extended by Congress in 1975. Act of April 21, 1975, Pub. L. No. 94-16, 89 Stat. 77.

13 Statement by President Ford, *supra* note 6, at 1366.

14 Congress provided that the Act would become effective 180 days after being signed by the President. CFTC Act, Pub. L. No. 93-463, § 418, 88 Stat. 1415.

15 *See* articles cited in note 8 *supra*.

16 Senate Report at 11.

17 Senate Report at 12. For a more detailed treatment of the historical development of futures trading in the United States, *see* T. Hieronymous, Economics of Futures Trading for Commercial and Personal Profit 69-92 (1971).

18 Prior to the CFTC Act, the Commodity Exchange Authority regulated livestock and grains, which are traded primarily in the Midwest. Numerous previously un-

The background of government regulation in many ways paralleled the growth of the futures system of marketing.[19] Over the years, State legislatures reacted to widespread resentment over speculative excesses and abuses of the system of futures trading by making repeated efforts to abolish futures trading. As early as 1844, a bill to prohibit futures trading was introduced in Congress; it was followed by many similar bills over the next fifty years. Speculation on the grain exchanges during the post World War I period of falling prices and farm depressions led to enactment of the Grain Futures Act of 1922[20] by Congress.[21] The primary objective of the Act was to regulate commodity exchanges rather than individual traders.[22] The Act designated the exchanges as "contract markets" and required them to be federally licensed. Licensed contract markets were required to take the main responsibility for preventing price manipulation by their members, although the Act did provide for government action against such manipulation.[23]

The Grain Futures Act proved ineffectual in preventing trading abuses.[24] Specifically, it did not provide the necessary legal authority to prevent excessive speculation by large traders, or to regulate commodity brokerage activities to prevent cheating, fraud and other unethical practices.

However, the Grain Futures Act was amended in 1936 and renamed the Commodity Exchange Act.[25] The new Act extended regulatory coverage to cotton and other specified commodities

regulated commodities, including the world commodities of sugar, coffee, cocoa, silver and foreign currencies, and several exchanges located in the New York area, are now subject to Commission regulation. *See* Address by Howard Schneider, General Counsel, CFTC, to Federal Bar Association Meeting, Atlanta, Georgia, Sept. 10, 1975, at 10-12. (Available at the Commission.)

19 *See* SENATE REPORT at 13. *See also* R. TEWELES, C. HARLOW & H. STONE, THE COMMODITY FUTURES GAME: WHO WINS? WHO LOSES? WHY? 11-14 (1974) [hereinafter cited as TEWELES].

20 Act of Sept. 21, 1922, Pub. L. No. 67-331, 42 Stat. 998.

21 The Congress had previously passed the Futures Act of 1921, but this Act was declared unconstitutional by the Supreme Court in Hill v. Wallace, 259 U.S. 44 (1922). The 1922 Act was based on the Congress' interstate commerce power instead of its taxing power, and was held constitutional in Board of Trade of the City of Chicago v. Olson, 262 U.S. 1 (1923).

22 *See* SENATE REPORT at 13.

23 *Id.*

24 *Id.* at 14.

25 *Id.*

as well as grains. It provided broad authority to deal with market abuses by traders as well as exchange members, to prosecute price manipulation as a criminal offense, and to curb excessive speculation by large market operators. It also extended regulations for the first time to cover commodity brokerage. Several amendments were made to the Commodity Exchange Act between 1936 and 1968, primarily to add additional commodities to the list of regulated commodities.[26] In 1968 Congress amended the Act substantially to require futures commission merchants to meet certain minimum financial standards. The amendment also increased the penalties for such violations as manipulation and embezzlement, authorized the issuance of cease and desist orders, required contract market enforcement of trading rules and contract terms, and added livestock products and frozen concentrated juice to the list of regulated commodities.[27] The Act was not amended again until passage of the Commodity Futures Trading Commission Act of 1974.

B. *Cash and Futures Contracts*

In order to understand the full import of the new Act it is first necessary to explain two basic concepts, cash and futures contracts, in this section and the mechanics of trading in the next section.

There are two basic types of commodity contracts: futures contracts, and cash or forward contracts.[28] The principal difference between cash contracts and futures contracts is their use.

Cash contracts are used for merchandising purposes, and may provide for either immediate or deferred delivery. They are usually, but not always, traded on informal, decentralized markets. In general, these cash contracts markets are not controlled by the CFTC Act except to prevent manipulation of commodity prices.

Futures contracts are used for speculative or hedging purposes.[29] A futures contract specifies the commodity, quantity and month

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26 *Id.*
27 *Id.*
28 Both contain the same basic terms regarding price, quantity, quality, time, place of delivery, terms of payments, and recourse in the event of default.
29 HIERONYMOUS, *supra* note 17, at 28-30, 200-03.

of future delivery.[30] Payment is not due until delivery. The terms are standardized, and the highly formalized rules of the organized exchanges, designated "contract markets," on which they must be traded.[31]

The primary purpose of futures trading is to enable producers, dealers, and processors of various commodities to shift the risk of price fluctuations to speculators through the process of hedging.[32] Basically, hedging allows producers, dealers, and processors to make contracts in advance for the sale of their goods and to protect themselves against price fluctuations by buying or selling futures contracts for an equal quantity of their product or material of manufacture. The reduction in risk permits the producer to sell and the processor to buy at lower prices, which theoretically benefits the consumer by lowering the price of the finished product. The speculator is willing to accept the risk of price fluctuation for the sake of possible gain.

C. *Mechanics of Trading*

Members qualified to trade on an exchange fall into four categories: floor trader; floor broker; scalper; and pit trader.[33] Speculators who are not one of these categories trade through futures commission merchants (FCM's).[34] A floor trader is employed by an FCM and may execute orders for the FCM's house account or for himself. A floor broker may or may not be a member of an FCM and executes orders for others, himself, or the FCM's house account. A scalper is a floor broker who trades for small gains and enters and offsets many transactions quickly in a single day. A pit trader also is one who tries to profit from price changes

30 *See* TEWELES, *supra* note 19, at 22-24; HIERONYMOUS, *supra* note 17, at 28-30.

31 TEWELES, *supra* note 19, at 22-24; HIERONYMOUS, *supra* note 17, at 28-30.

32 For a discussion of hedging *see* HIERONYMOUS, *supra* note 17, at 106-28; TEWELES, *supra* note 19, at 32-51. The theory of hedging is fairly simple, but in practice it is a complicated process. The Commission has been confronted with the problem of defining hedging and distinguishing "bona fide hedging" in its administration of the Act. See Section III(A)(1) *infra.*

33 HIERONYMOUS, *supra* note 17, at 44-51.

34 Futures commission merchants are individuals, associations, partnerships, corporations, and trusts engaging in soliciting or accepting orders for the purchase or sale of any commodity futures delivery on and subject to the rules of any contract market.

although taking bigger positions and staying with them for longer periods of time and larger price changes than a scalper.

Actual trading is done in pits or rings assigned for each commodity. The traders stand behind the ring and trade across it with each other. Exchange rules require that all bids and offers be cried out in a loud, clear voice so that all can hear and that each trader have an equal opportunity of acceptance. The trading scene may be charactrized as pure bedlam. Agreements which may involve millions of dollars are reached quickly with the first person to accept a bid or an offer by means of a hand signal. No signed document is involved at this stage. Observers located on raised pulpits in the pit observe the trading and record the trades, time stamp them and feed them into a communication system. This record is submitted to the clearing house for reconciliation at some specified time during the trading day.[35]

The clearinghouse is a party to all trades and the guarantor of all contracts.[36] On every trading day, each clearing house member receives cards from the trading floor which enumerate the details of each transaction in the pits. The clearing member enters the information on confirmation cards and forwards them to the clearinghouse. After all confirmation cards are received from all clearing members, the buy and sell records are matched and each day's business is balanced before the next day's trading begins.

A futures contract may be settled by delivery or by making an opposite or offsetting transaction in futures.[37] In the latter case, the owner of a futures contract to buy a specified commodity at a certain delivery month, at some time before the delivery month, sells a contract for the same commodity on the same delivery

35 For a description of exchange operations, see Teweles, *supra* note 19, at 24-28.

36 These clearinghouses are usually separate, non-profit corporations established by the exchanges for the purpose of reconciling all futures transactions and assuring the financial integrity of those transactions. Not all members of the exchange are members of the clearinghouse, and non-members must clear their trades through a clearinghouse member.

37 HIERONYMOUS, *supra* note 17, at 38-44. An infinitesimal number of futures contracts, less than one percent of contracts traded, ever reach maturity and are consummated. However, those that are consummated require that delivery and payment be made in accordance with the terms of the contract. Upon delivery, the futures contract becomes a cash transaction.

month; both are immediately cancelled and cease to exist. The contracts are settled by the payment of the value differences, if any result, when they are offset.

II. The Commodity Futures Trading Commission Act of 1974

In response to criticism that federal regulation of commodity futures trading was too narrow in scope and that the regulatory system established by the Commodity Exchange Act was inadequate,[38] Congress passed the Commodity Futures Trading Commission Act of 1974. The fundamental purpose of the Act is to insure fair practice and honest dealing and to provide some control over excessive speculative activity which causes injury to producers, consumers, and exchanges.[39] The Act reflects the Congressional desire that futures trading on contract markets should accurately respond to the forces of supply and demand.[40]

A. *The Commission*

The Commodity Exchange Authority established by the 1936 Commodities Exchange Act was criticized for lacking adequate authority to cope with improper practices.[41] In particular, the Authority did not have the power to approve or to require changes in the exchanges' rules, and could intervene only if the exchanges failed to enforce their own rules. The CFTC Act created a new Commodities Futures Trading Commission with expanded powers.[42]

In creating the new Commission, the Congress had first to decide whether the Commission, like the Authority which preceded it, should be an agency within the Department of Agri-

38 Statement by President Ford, *supra* note 6, at 1366. *See also* Fialka *The Food Speculators: Pricing Policemen Found Looking the Other Way*, Washington Star News, Sept. 25, 1975, at A-1, col. 1 and A-12, col. 1; Anthan, Mollenhoff & Risser, *Lax Commodity Regulation*, Des Moines Register, Feb. 18, 1973, at 1, col. 8.

39 *See* Senate Report at 14.

40 *See* CFTC Act § 215, 88 Stat. 1404, *amending* 7 U.S.C. § 12a (1970).

41 Robbins, *New Watchdog for Commodities*, April 25, 1975, at 1, col. 1.

42 The Commission consists of a Chairman and four other Commissioners, all appointed by the President, with the advice and consent of the Senate. CFTC Act § 101, 88 Stat. 1389, *amending* 7 U.S.C. §§ 2, 4 (1970).

culture.[43] The House Agriculture Committee, while disposed to reforming the CEA, sought to keep futures regulatory policy-making within the Department of Agriculture.[44] The Senate Agriculture and Forestry Committee, on the other hand, favored removing the regulatory agency from the Department's jurisdiction because of the inconsistency between the Department's responsibility for promoting farm income and the CFTC Act's view of the future markets as passive instruments designed to reflect rather than influence food prices.[45] The final version of the Act removed the regulation of commodity futures trading from the Commodity Exchange Authority, and assigned it to a new independent Commission.[46] In order to assure that the Department would have an input into the new agency's policies,[47] the Commission was to establish a liaison office in the Department of Agriculture.

In view of the need to restore public confidence in the commodity markets, the establishment of an independent agency with sufficient staff and legal authority was the best resolution of this issue. The Commodity Exchange Authority, as an agency of the Agriculture Department, had been criticized for its lax regulatory performance in recent years. Continuation of the Department's authority over the new Commission would have raised immediate doubts about its objective resolution of critical issues delegated to it in the Act and its willingness to take strong regulatory action when required. The liaison office will permit the Commission to consider the Department's concerns but will not require it to heed the policy line of Agriculture.

B. *Regulatory and Enforcement Authority*

Under the old regulatory scheme, all regulated futures were traded on "contract markets" by registered futures commission merchants and brokers.[48] All exchanges had to satisfy certain

43 The Commodity Exchange Authority (CEA) was an agency of the Department chaired by the Secretary of Agriculture. *See* SENATE REPORT at 21-22.
44 *Id.* at 20.
45 *Id.* at 21.
46 CFTC Act § 101(a)(3), 88 Stat. 1389.
47 CFTC Act § 101(a)(8), 88 Stat. 1390.
48 Commodity Exchange Act § 6f, 7 U.S.C. § 6f (1970), *as amended,* 7 U.S.C.A. § 6f (Supp. 1, 1975).

statutory requirements intended to prevent fraud and manipulation before they could be designated "contract markets."[49] Once the CEA made that designation, the contract markets regulated themselves. The CEA intervened only if the exchanges failed to enforce their own rules,[50] and then the principal sanction it had was to suspend or revoke the "contract market" designation.[51] Since the CEA was reluctant to take such a drastic step, it followed a passive regulatory policy.

The CFTC Act gives the Commission the ability to take an active role in preserving the integrity of futures trading by extending its authority to cover what is traded, who may trade, where trading may occur, and the rules under which it may be conducted. The Commission is empowered to compile information concerning futures trading in order to identify and discourage market abuses and to encourage investor activity.[52] In contrast to the CEA, the Commission has broad enforcement power to seek injunctive relief in court, to take action in emergency circumstances to restore orderly trading, and to impose increased penalties to punish violations.

The Commission evaluates the terms of the standardized futures contracts against the yardstick of a public interest test.[53]

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49 Commodity Exchange Act § 7, 7 U.S.C. § 7 (1970), *as amended*, 7 U.S.C.A. § 7 (Supp. 1, 1975).

50 Commodity Exchange Act § 513(a)b, 7 U.S.C. § 13(a) (1970), *as amended*, 7 U.S.C.A. § 13a (Supp. 1, 1975).

51. *Id.*

52 7 U.S.C.A. § 16 (Supp. 1, 1975).

53 7 U.S.C.A. § 7(g) (Supp. 1, 1975), *amending* 7 U.S.C. § 7 (1970). The Commission has partially interpreted this as an economic justification requirement. *See* Guideline on Economic and Public Interest Requirements for Contract Market Designation. Commodity Futures Trading Commission, May 13, 1975, Guideline No. 1, CCH COMMODITY FUTURES LAW Rep. 20617 (1975).

The test has been criticized by the exchanges as being irrelevant. Free marketers have contended that futures contracts serve an economic purpose when they sell and do not serve such purpose when they do not sell. The exchanges have claimed that it is extremely difficult to know in advance what the performance of a particular futures contract will be. They fear that some innovative contracts might not be allowed to be traded before they have the chance to establish a track record. On the other hand, the Commission is required to review commodity contracts to determine whether they serve the economic purposes of the nation, rather than simply provide a game for the traders. It requires that a contract be used, or can be used, either to set competitive prices or for hedging purposes. *See* Remarks by Commissioner Gary L. Seevers before the Commodity Futures Conference, Philadelphia, at 2 (CFTC Release No. 23-75, July 9, 1975 available at the Commission).

In order to protect participants in the market and insure fair dealing,[54] the Commission may, after notice and hearing, require changes in the contract terms. In contrast to the registration requirement for securities under the securities laws,[55] the Act does not require that commodity future contracts be individually registered. Individual registration is not necessary because the contracts are standardized[56] and the Commission has the authority to regulate the terms.

The Commission protects the integrity of futures trading by carefully screening all commodity futures trading professionals,[57] including those who are not members of an exchange.[58] Upon registration or periodic re-registration, the Commission may require information that it considers necessary to protect the public.[59] The Commission may establish fitness standards and tests for those who solicit and handle customer trades,[60] and refuse applications for registration in case of failure to satisfy its standards.[61] The Commission is also authorized to determine whether dual trading by floor brokers and futures commission merchants may be allowed and, if allowed, under what conditions.[62]

The CFTC Act amends the Commodity Exchange Act most significantly in the area of exchange rules.[63] All rules, regula-

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54 7 U.S.C.A. § 12a(7) (Supp. 1, 1975), *amending* 7 U.S.C. § 12a (1970).

55 Wolff, *Comparative Federal Regulation of the Commodities Exchanges and the National Securities Exchanges*, 38 GEO. WASH. L. REV. 223 (1969).

56 *See* note 31 *supra*.

57 7 U.S.C.A. § 6k(1) (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970), provides for registration of all persons associated with a futures commission merchant. 7 U.S.C.A. §§ 6l-m (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970), requires registration of commodity trading advisors and commodity pool operators. 7 U.S.C.A. § 6p (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970), gives the Commission authority to specify standards of training, experience and other qualifications for commission merchants, floor brokers, and persons associated with them.

Registration requirements for futures commission merchants and floor brokers have been expanded to include persons associated with futures commission merchants, commodity pool operators, and commodity trading advisors, in order to protect the investor from trading abuses. *Id.*

58 7 U.S.C.A. § 12a(8) (Supp. 1, 1975), *amending* 7 U.S.C. § 12a (1970).

59 7 U.S.C.A. § 6n (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970).

60 7 U.S.C.A. § 6p (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970).

61 *See* note 59, *supra*.

62 7 U.S.C.A. § 6j (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970).

63 Under the Act, futures trading may be done only on organized contract markets, where trading procedures can be reviewed by the Commission. 7 U.S.C.A.

tions, and bylaws of contract markets relating to contract terms and conditions and other trading requirements, except margin rules,[64] must be submitted to the Commission for approval.[65] The Commission may, after notice and hearing, alter or supplement exchange rules, except those relating to margin requirements, and require the exchanges to adopt these modifications.[66] It may review exchange decisions and disciplinary actions.[67] The Commission can also act quickly in an emergency by ordering the exchanges to adopt necessary procedures to alleviate the disruption of orderly futures trading.[68]

The Commission's comprehensive information program will

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§ 6 (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970). One of the requirements for an exchange to be designated a contract market is a showing that it will continue to comply with the requirements of Section 5(a)(8) of the Commodity Exchange Act. Under that provision, the contract market must enforce all of its bylaws, rules, regulations, and resolutions which relate to contract terms and conditions and other trading requirements, which have been approved by the Commission. In support of its application for designation as a contract market, each board of trade must submit a description of its rule enforcement program designed to comply with Section 1.51 of the regulations and showing how compliance will be achieved, as well as the resources devoted to the rule enforcement program. *See* Guidelines for Contract Market Rule Enforcement Program, Commodity Futures Trading Commission, May 13, 1975, Guideline No. 2, CCH COMMODITY FUTURES LAW Rep., § 20,042 at 20,620.

64 This term is often confused by laymen and legislators alike because it has different meanings in the commodities and securities industries. Margin in the commodities industry serves as a security deposit to insure that both parties to a futures transaction will perform their obligations and responsibilities under the futures contract. In the securities industry on the other hand, margin is the amount of money which a broker may lend to a customer. Such lending to customers by commodity brokers is strictly prohibited by the rules of most commodity exchanges.

65 7 U.S.C.A. § 7a(12) (Supp. 1, 1975), *amending* 7 U.S.C. § 7a (1970). Certain operational and administrative rules, and emergency exchange rules may be exempted by the Commission from this requirement.

66 7 U.S.C.A. § 12a(7) (Supp. 1, 1975), *amending* 7 U.S.C. § 12a (1970).

67 7 U.S.C.A. § 12c(B)(2) (Supp. 1, 1975), *amending* 7 U.S.C. § 12b (1970).

68 7 U.S.C.A. § 12a(9) (Supp. 1, 1975), *amending* 7 U.S.C. § 12a (1970). This is one of the most controversial provisions of the Act. The term "emergency" is defined in this section of the Act to mean "[T]hreatened or actual market manipulations and corners, [and] any act of the United States or a foreign government . . . which prevents the market from accurately reflecting the forces of supply and demand for such commodity." The legislative history of this provision makes it clear that the "emergency" itself must, in the Commission's judgment, have a greater adverse impact on the market than the action that the Commission proposes to take. It also emphasizes that nothing in the emergency powers section, the injunctions section, or any other provision of the Act is to be used by the Commission to violate unnecessarily the sanctity of contract. *See* SENATE REPORT at 25; Johnson, *The Commodity Futures Trading Commission: Newest Member of Each Exchange's Management Team*, 34 FED. B. J. 173, 177-79 (1975).

deter abuses by identifying market manipulation,[69] and encourage investment by giving investors current market information.[70] Clearinghouses, exchanges, futures commission merchants, and brokers must maintain daily trading records. Brokers and FCM's must report the amount of trading by individual customers.[71] The Commission has broad investigatory powers to examine these records, as well as other matters ranging from market conditions to customer complaints of alleged violations.[72] Investigatory findings may be reported to the public.[73]

The Commission, unlike the CEA, can go into court to enjoin any contract market or person from violating the Act or restraining trading in any commodity for future delivery.[74] The Com-

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69 7 U.S.C.A. § 20 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970). Neither the Commodity Exchange Act, as amended by the CFTC Act, nor preceding legislation, contains a definition of manipulation. Although discussed in Congressional hearings and debates, definition of this term has been deliberately left to the courts. The courts have given a succession of implied definitions. In *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962), the court accepted the following definition:

> Manipulation is any and every operation or transaction or practice . . . calculated to produce a price distortion of any kind in any market either in itself or in relation to other markets. If a firm is engaged in manipulation it will be found using devices by which the prices of contracts for some one month in some one market may be higher than they would be if only the forces of supply and demand were operative . . . . Any and every operation, transaction, or device, employed to produce these abnormalities of price relationship in the futures markets, is manipulation.

"The most prevalent form of alleged manipulations prosecuted by the Commodity Exchange Authority [involved]: (a) a dominant or controlling futures position; (b) a dominant or controlling position in deliverable supplies; (c) an artificial price; and (d) manipulative intent. Most cases have also included elements of false information, concealment of records, concealment of positions, and collusion." HIERONYMOUS, *supra* note 17, at 308. For a discussion of past manipulations see HIERONYMOUS at 297-312.

70 The Commission publishes this data in cooperation with other federal agencies. 7 U.S.C.A. § 20 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

71 7 U.S.C.A. § 6g(2)-(3) (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970). Pursuant an an interpretation of this provision, the Commission has also requested major grain firms to report each grain sale to a foreign government on the date such agreement is reached, regardless of whether a contract has been formally signed. 40 Fed. Reg. 29795 (1975). This requirement was prompted by the Russian wheat deal of 1972, in which large purchases of wheat were conducted in secret, and which resulted in spiraling food prices for the consumer.

72 7 U.S.C.A. §§ 18, 20 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

73 7 U.S.C.A. § 20(a) (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

74 7 U.S.C.A. § 13a-1 (Supp. 1, 1975), *amending* 7 U.S.C. § 13a (1970). The House version, H.R. 13113, 93d Cong., 2d Sess. (1974), would have authorized the Commission to enjoin any person or contract market "about to" or "in a position" to

mission may also request the Attorney General to bring an action in lieu of bringing the action itself.[75] Penalties have been increased substantially to a maximum of $100,000 and may be imposed in both administrative and criminal proceedings.[76] Additionally, failure to obey a cease and desist order of the Commission may be punished by imprisonment for up to one year.[77]

The Act's injunctive provision is patterned after a similar provision contained in the Securities and Exchange Act,[78] in that the Commission is limited to seeking civil relief in court.[79] When criminal prosecution is deemed necessary, the Commission may transmit available evidence to the Attorney General who may, in his discretion, institute criminal proceedings under the Act.[80]

The Act gives the Commission far-reaching authority over

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violate the Act, or if there was a "danger" of a violation occurring. Industry representatives argued against the emergency provision because of the potential for abuse of such broad power. The Senate version modified the provision by eliminating the Commission's authority to enjoin a person merely for being "in a position to" violate the Act, but retained the other subjective language authorizing the Commission to enjoin potential violations.

The Commission's power to seek an injunction against any contract market or person "about to engage" in a violation will probably be limited by the courts to cases where a real, and not an imagined, injury is about to be inflicted or has been inflicted. An injunction will not usually be granted on the basis of a mere apprehension of injury, or on the basis of a probable future event. The court must be satisfied that the apprehension is well grounded; that there is reasonable probability of real injury; and that there is no adequate remedy at law if the injunction is not granted.

The federal securities laws permit an injunction when a violation is "about to" occur but do not extend that authority to enjoin those who are merely "in a position to" commit a violation or where there is simply a "danger" of violation. Securities Act of 1973 § 20(b), 15 U.S.C. § 77t(b) (1970); Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u(e) (1970). Pursuant to those provisions, no injunctions have been granted absent proof of an actual or threatened violation.

Empowering independent regulatory agencies to seek injunction in the courts directly is not a novel provision. The National Labor Relations Board, for example, is authorized to sue for an injunction in secondary boycott cases, 29 U.S.C. § 160(l) (1970), and the SEC may, in its discretion, seek injunctive relief in a proper District Court of the United States.

75 7 U.S.C.A. § 13a-1 (Supp. 1, 1975), *amending* 7 U.S.C. § 13a (1970).

76 7 U.S.C.A. §§ 8, 9, 13a, 13b, 15 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 8, 9, 13b, 15 (1970).

77 7 U.S.C.A. §§ 13a, 13b, (Supp. 1, 1975), *amending* 7 U.S.C. §§ 8, 9, 13b, 15 (1970).

78 *Compare* 15 U.S.C. § 78u(e) (1970) *with* 7 U.S.C.A. § 13a (Supp. 1, 1975), *amending* 7 U.S.C. § 13a (1970).

79 *Compare* 15 U.S.C. § 78u(f) (1970) *with* 7 U.S.C.A. § 13a (Supp. 1, 1975), *amending* 7 U.S.C. § 13a (1970).

80 7 U.S.C.A. § 13a (Supp. 1, 1975), *amending* 7 U.S.C. §§ 8, 9, 13b, 15 (1970).

every aspect of futures trading, and the staff resources needed in order to be an active regulator of the commodity markets. It also provides the independence needed for the Commission to establish credibility with the public. The fulfillment of the investigatory and informational role of the Commission will aid the public in understanding an industry which has been long misunderstood. In sum, the Act has created a modern agency to meet the challenge of regulating a complex and rapidly growing industry which is vital to the national economy.

C. *Exclusive Jurisdiction of the Commission*

The Act gives the Commission exclusive jurisdiction over all commodity futures transactions executed on domestic boards of trade.[81] The term "commodity" is defined to include "all goods and articles, except onions, and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."[82] The Commission also has exclusive jurisdiction over options trading in commodities,[83] and the sale of gold and silver coin and bullion on margin (or "leverage") accounts.[84] In effect, the Commission is entitled to regulate all dealings in

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81 7 U.S.C.A. § 2 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 2, 4 (1970).

82 *Id.* Futures trading in onions is prohibited by federal law, 7 U.S.C. § 13-1 (1970). However, this section does not expressly prohibit trading options in onions in the cash market. *See* Address by Howard Schneider, General Counsel, Commodity Futures Trading Commission, before the Federal Bar Association meeting, Atlanta, Georgia, September 10, 1975, at 10-12.

83 7 U.S.C.A. § 2 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 2, 4 (1970).

84 7 U.S.C.A. § 15a (Supp. 1, 1975), *amending* 7 U.S.C. § 15 (1970). The Commission has adopted an antifraud rule for leverage transactions, *see* 17 C.F.R. § 30.03, (1975), and has proposed a temporary rule requiring any person offering such transactions to submit a plan of operation to the Commission for its approval before expecting any leverage transactions. *See* 17 C.F.R. § 30.04 (1975). In this proposed temporary rule, the Commission defined "leverage transactions" as "any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract," and a "standardized contract" as "any contract effecting a leverage transaction which is or is proposed to be offered on the same or substantially similar terms to ten or more offerees." 17 C.F.R. § 30.04(a) (1975). For a discussion of leverage contracts *see generally*, Report for the Commodity Futures Trading Commission: Trading in Leverage Contracts for Gold and Silver, prepared by Alfred D. Ulrog, Jr. for the CFTC Program Study Group, April 18, 1975 (available at the Commission).

commodities covered by the Act unless its jurisdiction is ousted by specific statutory prohibitions.[85]

1. State Jurisdiction Superseded

Congress sought to centralize regulatory authority in the Commission and to exclude state regulation in order to avoid the growing diversity of state regulatory provisions affecting futures trading. Congress also wanted to reduce the bureaucratic red tape inherent in requiring a person or an exchange to register with several separate state agencies.[86]

The legislative history clearly indicates that Congress intended to preempt state jurisdiction over the transactions that the Act covers.[87] A sentence in the Commodity Exchange Act which could have been construed as continuing state law in the field was purposefully deleted from the Act[88] to assure preemption of state regulatory authority. The Conference Report on the final bill stated that the Commission "would preempt the field insofar as futures regulation is concerned."[89] Therefore, if any substantive state law regulating futures trading is contrary to or inconsistent with the Act, the Act will govern.[90] In view of the broad grant

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85 SENATE REPORT at 35. The Commission also has jurisdiction over transactions in foreign currency, security warrants and rights, resales of installment loan contracts, repurchase options, government securities or mortgages, and mortgage purchase commitments, if these transactions involve the sale thereof for future delivery on a board of trade. 7 U.S.C.A. § 15a (Supp. 1, 1975), *amending* 7 U.S.C. § 15 (1970).

86 Address by John B. Rainbolt, II, Vice-chairman, CFTC, before the North American Securities Administrators' Conference, Mackinac Island, Michigan, Sept. 9, 1975.

87 SENATE REPORT at 35.

88 *Id.*

89 *Id.*

90 *Id.* at 36. The Constitutional authority for preemption of state laws regulating activities under the Act is U.S. Const. art. I, § 8, cl. 3 and U.S. Const. art. VI, cl. 2 of the United States Constitution. On preemption, see Northern States Power Co. v. State of Minnesota, 447 F.2d 1143, 1146 (8th Cir. 1971).

However, the Act provides that "pending proceedings under existing law shall not be abated by reason of any provision" of the 1974 Act, "but shall be disposed of pursuant to the applicable provisions of the Commodity Exchange Act, as amended, in effect prior to the effective date of this Act." CFTC Act § 412, 88 Stat. 1414. This section of the Act was recently interpreted by the Texas Court of Civil Appeals as not being applicable to an appeal by the State of Texas pending at the time the Act became effective. The appeal was from a district court decision holding that the State did not have jurisdiction to regulate margin transactions after April of authority to the Commission, the conferees did not contemplate a need for any supplementary regulation by the states.[91]

Notwithstanding the exclusive jurisdiction provision of the Act, the states may still prosecute fraud under state laws of general application. Additionally, the states may seek to enjoin business conduct which violates the Commodity Exchange Act or regulations issued pursuant thereto, based on the doctrine of *parens patriae*, under which a state may act as protector of its citizens and guardian of their interests. They may also take action against persons who are required to register with the Commisison but who have not done so. The Commission has indicated a willingness to cooperate with states to establish a cooperative enforcement effort.[92]

2. SEC Jurisdiction

The Commission's jurisdiction over futures trading can not supersede or limit the jurisdiction of the Securities and Exchange Commission or other regulatory authorities under federal or state laws, or restrict them in carrying out their duties and responsibilities in accordance with such laws.[93] However, the dividing line between the jurisdictions of the Commission and the SEC is not entirely clear.

Private parties have in the past invoked the Securities Act of 1933[94] and the Securities and Exchange Act of 1934[95] with respect to commodity transactions, claiming that the method of trading in futures contracts resulted in the creation of a security.[96] The Supreme Court's broad concept of "security" under the federal

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21, 1975, the effective date of the Act, and not allowing a permanent injunction which would have enjoined future transactions after that date. *See* State of Texas v. Monex International, Ltd., COMMODITIES L. REP. ¶ 20,083 (11th Sup. Jud. Dist. 4770, Aug. 29, 1975).

91 SENATE REPORT at 36.

92 The Commission's office of General Counsel is preparing a memorandum outlining a cooperative enforcement program with the states. *See* Address by John Rainbolt, *supra* note 86, at 10.

93 7 U.S.C.A. § 2 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 2, 4 (1970).

94 15 U.S.C. §§ 77a, *et seq.* (1970).

95 15 U.S.C. §§ 77, *et seq.* (1970).

96 *See* Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974).

securities laws appears to support this contention. The Court has stated that "[i]n the Securities Act the term 'security' was defined to include by name or description many documents in which there is common trading for speculation or investment — [T]he reach of the Act does not stop with the obvious and commonplace."[97] In formulating what has become known as the *Howey* test, the Court stated that "[an] 'investment contract' involves investment of money in a 'common enterprise' with 'profit' to come solely from the efforts of others. Form [is to be] disregarded for substance and emphasis [is to be] placed on economic reality."[98] The Court has also held that "[t]he subjection of the investor's money to the risk of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction."[99] Despite the Supreme Court's language, however, the weight of authority in the lower courts supports the view that the provisions of the securities laws do not extend to transactions involving trading in commodities.[100]

The Act attempts to alleviate confusion between regulatory schemes by giving the Commission exclusive jurisdiction with respect to commodity transactions by trading advisors, pool operators and other professionals, and authorizing it to police them based upon what they or associated persons have done.[101] It applies a broad fiduciary responsibiilty to these professionals in terms that parallel SEC Rule 10b-5.[102] With regard to sales on margin of gold and silver bullion, bulk silver coins and bulk gold coins, the Act

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97 SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

98 SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

99 Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

100 For example, federal courts have held that discretionary commodity accounts, which are subject to CFTC jurisdiction, are not subject to SEC regulation. Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972); Wasnowic v. Chicago Board of Trade, 352 F. Supp. 1066 (M.D. 1972), *aff'd* 491 F.2d 752 (3rd Cir. 1973), *cert. denied*, 416 U.S. 994 (1974). *See also* Stuckey v. duPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359 (S.D.N.Y. 1966). Some courts, however, have adopted the contrary view. *See e.g.*, Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974); *cf.* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

101 7 U.S.C.A. § 61-o (Supp. 1, 1975), *amending* 7 U.S.C. § 6 (1970).

102 17 C.F.R. § 240.10b-5 (1975).

gives exclusive jurisdiction to the Commission and express authority to adopt rules to assure financial solvency of the transaction or to prevent manipulation.[103] However, those transactions not on margin are subject to SEC jurisdiction.[104]

Recognizing that confusion might remain about the extent of the two Commissions' jurisdictions, the House Agriculture Committee Report stated that the two Commissions should consult and cooperate in determining how to exercise their respective jurisdictions in the public interest.[105]

3. State and Federal Court Jurisdiction

Although both the House and Senate sought to centralize regulatory jurisdiction over futures trading in the Commission, they did not wish to prevent injured persons from seeking redress in federal and state courts.[106] The inclusion of a provision of the Act which authorized the Commission to hear investor complaints and to award damages or "reparations"[107] did not allay this concern. The Senate, therefore, added the provision that "nothing in [the Act] shall supersede or limit the jurisdiction conferred on courts of the United States or any State."[108] Thus, injured persons may continue to sue in federal or state court.[109] But Congress has not revoked the doctrine of primary regulatory jurisdiction. While an injured person may elect initially to bring suit in a court rather than proceed before the Commission, the Act does not preclude the court from referring issues in the case to the Commission for review.[110]

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103 7 U.S.C.A. § 15a (Supp. 1, 1975), *amending* 7 U.S.C. § 15 (1970).

104 *Id.*

105 H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 29 (1974) [hereinafter cited as House Report]. For a comparative analysis of the federal regulation of commodity and securities exchanges, *see* Wolff, note 55 *supra.*

106 Senate Report at 54.

107 7 U.S.C.A. § 18 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

108 7 U.S.C.A. § 13-1 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 2, 4 (1970).

109 *See* Address by John Rainbolt at 8, *supra* note 109. This is similar to the procedure under the securities Act, §§ 77k-1, 15 U.S.C. §§ 77k-1 (1970). *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (proxy violations); Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6 (1971).

110 *See, e.g.,* Ricci v. Chicago Mercantile Exchange, 409 U.S. 289 (1973); Chicago Mercantile Exchange v. Deaktor, 414 U.S. 113 (1973).

4. Commission Action to Assert Jurisdiction

The Commission initially took two steps to assert its exclusive jurisdiction. First, the Commission intervened[111] in a Securities and Exchange Commission case.[112] The complaint alleged that the defendants had offered and sold investment contracts, evidence of indebtedness, and participations in profit sharing agreements in the form of purported options on commodity futures contracts, in violation of the registration[113] and antifraud[114] provisions of the Securities Act of 1933, and the broker dealer registration requirements of the Securities Exchange Act.[115]

In its amicus curiae memorandum, the Commission expressed no opinion as to whether the defendant's alleged activities, which occurred prior to the effective date of the CFTC Act, April 21, 1975, involved the offer and sale of a "security."[116] The Commission stated that the CFTC Act should not be held to affect the jurisdiction of the SEC prior to April 21, 1975,[117] but asserted that the activities alleged in the SEC complaint were now plainly within the jurisdiction of the Commission. The .Commission went on to state that the facts alleged would permit a court to conclude that a reasonable probability existed that the defendants, unless enjoined, might violate the antifraud provisions of the Commodity Exchange Act, as amended by the CFTC Act of 1974, and the rules adopted thereunder by the CFTC.[118]

Second, the Commission has adopted antifraud rules covering (1) leverage contracts,[119] (2) options trading for newly regulated commodities,[120] and (3) futures contracts traded on other than domestic contract markets.[121] These areas had previously been

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111 See CCH COMMODITY LAW REP. No. 8, at 5, (August 27, 1975).

112 SEC v. American Commodity Exchange, Civil Action No. 15-0436-C (W.D. Okla. 1975).

113 Act of May 27, 1933, Pub. L. No. 73-22, 48 Stat. 74, 77, codified at 15 U.S.C. § 77e (1970).

114 *Id.*, 48 Stat. 74, 84, codified at 15 U.S.C. § 77q(a) (1970).

115 Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o(a) (1970), *formerly* ch. 404, Title I, § 15, 48 Stat. 881, 895.

116 *See* note 112 *supra*.

117 CFTC Act § 418, 88 Stat. 1415.

118 *See* note 133 *supra*.

119 17 C.F.R. § 30.03 (1975).

120 17 C.F.R. § 30.01 (1975).

121 17 C.F.R. § 30.02 (1975).

regulated by the SEC under Rule 10b-5,[122] but had escaped coverage under Section 4b of the CFTC Act because trading did not occur on the contract markets. In asserting jurisdiction, the Commodities Futures Trading Commission recognized that the "willful behavior" test of Section 4b was stiffer than the test under SEC Rule 10b-5. Rather than reduce the level of scrutiny of these transactions, the Commodities Futures Trading Commission dropped the "willful behavior" test from the regulations applied to these transactions.[123]

5. Potential for Future Conflict

Despite the efforts by Congress to clarify the confusion in the courts regarding the definitions of commodities and securities, and to delineate the jurisdiction of the new Commission vis-à-vis the SEC and state regulatory agencies, the Commission and the SEC already are at odds over jurisdictional matters. Moreover, some of the states may continue to assert jurisdiction over some commodity futures transactions, especially options transactions. Thus, the prospect remains that bureaucratic infighting may continue, and substantial litigation may be necessary to resolve the various jurisdictional conflicts.

D. *Antitrust Review*

The fact that commodites futures exchanges promulgate rules for the trading of commodities futures contracts presents the possibility that the exchanges may be charged with violations of the federal antitrust laws. Recent class actions against commodities futures exchanges have indeed made such charges. In *United States v. Board of Trade of the City of Chicago*,[124] for example, plaintiffs claimed that the fixing of minimum commissions by the exchanges violated the antitrust laws even though the prac-

122 *See* Report for the Commodity Futures Trading Commission: Regulatory Gap, at 2, Project Report #201-h, (April 1, 1975) prepared by CFTC Program Study Group.
123 40 Fed. Reg. 26505, n.2 (1975).
124 No. 71C 2875 (N.D. Ill. June 28, 1974).

tices antedated those laws and had continued unchallenged for decades with the full knowledge of the government.[125]

Courts have construed even statutory antitrust exemptions very narrowly. The Supreme Court has followed a policy of limiting or ignoring antitrust immunity where Congress has been silent regarding the relation between a regulatory law and the antitrust laws. In *Silver v. New York Stock Exchange,*[126] the Court held that, in the absence of regulatory supervision over the application of exchange rules, the antitrust laws applied to the stock exchanges.[127] The Court went on to state that:

> [A]ny repealer of the antitrust laws must be discerned as a matter of implication and "[i]t is a cardinal principle of construction that repeals by implication are not favored." [citing cases] Repeal 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.[128]

In *Silver,* however, the Court explicitly reserved the question of whether the antitrust laws would apply to the stock exchange if review of exchange self-regulation were provided through another regulatory scheme.[129]

The question left open in *Silver* was squarely presented in *Gordon v. New York Stock Exchange, Inc.*[130] *Gordon* involved a class action suit filed in 1971 against the New York Stock Exchange, American Stock Exchange, and two member firms. Plaintiff claimed that the system of fixed commission rates utilized by the exchanges for transactions of less than $500,000 violated the Sherman Antitrust Act.[131] In contrast to the circum-

125 The Chicago Board of Trade case was settled when the defendant exchanges agreed to phase out minimum commissions. *See* CCH COMMODITY FUTURES LAW REP. ¶ 20011 (1975).

126 373 U.S. 341 (1963).

127 *See also* United States v. Philadelphia National Bank, 374 U.S. 321 (1963); California v. Federal Power Commission, 369 U.S. 482 (1962); United States v. Radio Corporation of America, 358 U.S. 334 (1959); Federal Maritime Board v. Isbrandtsen, 356 U.S. 481, 499-500 (1958).

128 Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963).

129 *Id.*

130 Gordon v. New York Stock Exchange, Inc., 43 U.S.L.W. 4958 (U.S. June 26, 1975).

131 The District Court granted the defendant's motion for summary judgment, and dismissed plaintiff's complaint. 366 F. Supp. 1261 (S.D.N.Y. 1973). The Court of Appeals affirmed, 498 F.2d 1303 (2d Cir. 1974).

stances of *Silver*, the SEC in *Gordon* had direct regulatory powers over exchange rules and practices with respect to fixing reasonable rates of commission, and was also authorized to require alteration or supplementation of those rules and practices. The Court pointed out that all rate changes since 1934 had been brought to the attention of the SEC and that the SEC had taken an active role in reviewing proposed rate changes during the last fifteen years. The Court concluded that *Gordon* involved explicit statutory authorization for SEC review of all exchange rules and practices dealing with rates of commission. Therefore, the Court held that the requirements for implied repeal of the antitrust laws in this instance were clearly satisfied because "[t]o permit operation of the antitrust laws with respect to commission rates, as urged by petitioner Gordon and the United States as amicus curiae, would unduly interfere, in our view, with the operation of the Securities Exchange Act."[132]

The Commodities Futures Trading Commission Act provides that the Commission itself must, in the first instance, attempt to resolve the problem of antitrust liability arising from the self-regulation of commodities futures trading exchanges.[133] The Act directs the Commission, in the process of approving exchanges' rules,[134] to "take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act."[135]

The legislative history of the Act indicates that the Congress, acting before the Supreme Court's decision in *Gordon*, determined to give the Commission rather than the courts, the initial role in applying antitrust policies to the commodities futures

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132 Gordon v. New York Stock Exchange, Inc., 43 U.S.L.W. 4958, 4966 (U.S. June 26, 1975).

133 *See* SENATE REPORT at 48.

134 7 U.S.C.A. § 7a(12) (Supp. 1, 1975), *amending* 7 U.S.C. § 7a (1970).

As mentioned earlier, each exchange must submit its bylaws or rules covering contract terms and conditions and other trading requirements to the Commission for approval before those rules can become effective. Section 5(a)(12) of the Commodity Exchange Act, as amended.

135 7 U.S.C. § 19 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

Antitrust review proceedings may be treated as "rulemaking" by the Commission in that such proceedings may involve "approval or prescription for the future" of matters within 5 U.S.C. § 551(4) (1970). The prospect of judicial review was recognized by Congress. *See* SENATE REPORT at 23.

exchanges. Congress was strongly urged to make clear its intent with regard to the relationship between the Act's regulatory standards and the antitrust laws.[136] The Senate Report indicates that the Congress intended to allow the public interest represented by the antitrust laws to be vindicated through the regulatory process in the Commission,[137] presumably because the Congress felt that regulatory agencies are better able to guard investors and the public. Granting antitrust immunity to actively supervised exchanges[138] appeared to prevent the dilemma of agency rules conflicting with court decisions.[139] The House Report recognized the "[c]onfusion in court decisions . . . with regard to the antitrust consequences of self-regulating activities of exchanges"[140] and the "growing difficulties facing exchanges engaged in self-regulatory actions as a result of private plaintiffs seeking damages against self-regulating activities of the markets,"[141] and decided to include the "least anti-competitive means test" in the Act.[142]

The *Gordon* case appears to support Congress' decision to subordinate the antitrust laws to independent regulatory schemes. However, the legislative history of the Act indicates that Congress did not favor granting an automatic antitrust exemption to Commission rules or to exchange bylaws subject to Commission approval.[143] Inclusion of the least anti-competitive means pro-

136 *See* House Report at 44-48. *See also* Hale & Hale, *Regulation: A Defense to Anti-Merger Litigation*, 54 Ky. L.J. 683, 715 (1966).

137 *See* Senate Report at 28.

138 This is to be distinguished from a "pervasive" regulatory scheme. The SEC action to control the minimum commission rules, pursuant to express statutory authorization, served to take this practice out of the antitrust field. A broad antitrust immunity regarding all phases of exchange activity was not at issue. Gordon v. New York Stock Exchange, 43 U.S.L.W. 4958 (U.S. June 26, 1975).

139 House Report at 48.

140 *Id.*

141 *Id.*

142 *See* Senate Report at 8, 22-23. In order to avoid imposing a procedural burden on the Commission, it made clear its intention that the Commission was not required to consider antitrust and anticompetitive matters in separate proceedings.

143 The Justice Department had objected to the original language of H.R. 11955 containing explicit exemption language and argued that existing case law, and particularly the test formulated by the Supreme Court in Silver v. New York Stock Exchange, 373 U.S. 341 (1963), "provides an adequate antitrust exemption for those activities of contract markets necessary to achieve valid objectives of the Commodity Exchange Act." House Report at 23-7. The Committee accepted the

vision in the Act clearly reflects the Congressional intent that antitrust inquiry should occur before the rules in question become effective, and while they are still under review by the Commission, rather than later in court after reliance on their validity.[144] The fact that the Commission is given initial jurisdiction, nonetheless, does not mean that Commission orders are immune from court review.[145]

The scope of judicial review of Commission orders with respect to antitrust policies remains unclear. In two recent decisions[146] the Supreme Court deferred the question of antitrust review by invoking the doctrine of primary jurisdiction and deferring to the Commodity Exchange Authority on decisions where the agency has expertise to deal with "intricate and technical facts of the commodity industry."[147] The Court made clear, however, that it is not bound by an agency decision, and pointed out that an adjudication by the agency did not necessarily settle the question of immunity from liability under the antitrust laws.[148]

E. *Dispute Resolution*

The CFTC Act added new provisions to the Commodity Exchange Act establishing two procedures by which disputes could be promptly and equitably resolved. First, it requires the Commission to establish by January 23, 1976, a reparation procedure for handling complaints against any person registered under the Act.[149] Secondly, it requires the contract markets to provide a fair and equitable procedure, through arbitration or otherwise, for the settlement of customers' claims (but not claims of futures

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arguments of the Justice Department, relying on the Department's assurances that antitrust exemption would exist for any exchange activity which was necessary to achieve the purpose or objectives of the regulatory statute.

144 *See* HOUSE REPORT at 34-35.

145 4 U.S.C. § 701 *et seq.* (1970). *See also* City of Lafayette v. Securities and Exchange Commission, 454 F.2d 941 (D.C. Cir. 1971), *aff'd*, 411 U.S. 747 (1973); Independent Broker-Dealers' Trade Association v. Securities and Exchange Commission, 442 F.2d 132 (D.C. Cir. 1971).

146 Chicago Mercantile Exchange v. Deaktor, 414 U.S. 113 (1973); Ricci v. Chicago Mercantile Exchange, 409 U.S. 289 (1973).

147 Deaktor, *supra* note 146, at 115.

148 *Id.*

149 7 U.S.C.A. § 18 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

commission merchants or floor brokers) against any of its members or employees.[150]

1. Reparation Procedure

The reparations procedure established by the Act is similar to those provided for in the Perishable Agricultural Commodities Act (PACA).[151] However, unlike the PACA reparations scheme, a party dissatisfied with the results of a hearing may not apply to the District Court for a trial de novo.[152]

The Commission will consider complaints based on any violation of the Commodity Exchange Act or rules and regulations promulgated thereunder.[153] If the facts alleged warrant it, the Commission may send a copy of the complaint to the respondent, and conduct an investigation.[154] If further proceedings are in order, the respondent will be afforded an opportunity to be heard before an Administrative Law Judge.[155]

Upon finding a violation, the Commission will determine the damages and order the respondent to pay the complainant.[156] The Commission's order is reviewable by the Court of Appeals,[157] but findings of fact are conclusive if supported by the weight of evidence.[158] If the respondent refuses to pay and does not appeal, he will be prohibited from trading on contract markets and his registration will be automatically suspended.[159]

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150 7 U.S.C.A. § 7a (Supp. 1, 1975), *amending* 7 U.S.C. § 7a (1970).

151 7 U.S.C. § 499(e)-(g) (1970).

152 7 U.S.C.A. § 18g (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

153 The Commission will consider a complaint against persons registered as futures commission merchants, floor brokers, persons associated with futures commission merchants or with agents thereof, commodity trading advisors, or commodity pool operators. A complaint based on any violation of the Commodity Exchange Act or rules, regulations, or orders promulgated thereunder can be filed by any person up to two years after accrual of the cause of action alleged therein. *Id.* § 18a.

154 *Id.* § 18b.

155 Proof in support of the complaint and of respondent's answer may be supplied by deposition or verified statements of fact, if the complaint claims damages not exceeding $2500.00. *Id.*

156 *Id.* § 18e-f. If the reparation award is not paid, the complainant has three years to enforce the award in the appropriate United States District Court.

157 *Id.* § 18g.

158 7 U.S.C.A. § 9, *amending* 7 U.S.C. § 9 (1970).

159 *Id.* § 18h.

Since aggrieved parties may appeal only to the Court of Appeals,[160] the Commission hearings probably must satisfy the requirements of due process. As a result, the reparation procedures will require a great deal of the Commission's energies and resources. In fact, one Member of the Commission has already expressed concern that the reparations procedure "could make [the Commisison] a huge small claims court for the Commodity industry."[161]

Nonetheless, since the interests of the parties involved are significant, the requirement of due process seems justified. But a time-consuming and burdensome reparation procedure would divert the Commission's limited resources from its regulatory function. This would cast doubt on the ability of the Commission to resolve disputes effectively, thus threatening its reputation from the very beginning.

2. Arbitration

Arbitration is an effective and quick method for resolving disputes, saving time and costs for both parties to a dispute. This makes it especially suitable for an industry where time is of the essence.

While some exchanges had informal arbitration procedures before the Act, they were not uniform and did not provide all the necessary safeguards the Commission now requires. Each exchange must now establish procedures for claims under $15,000.[162] A contract market may also establish separate procedures for claims over $15,000,[163] but such mechanisms must not interfere or delay the adjudication of claims for the smaller amounts.[164] The Commission has proposed rules to establish requirements necessary for a fair and equitable settlement pro-

160 *Id.* § 18g.

161 *See* Address by Commissioner Gary L. Seevers before the Regulatory Reform Conference, Washington, D.C., Sept. 11, 1975 at 4 (available at the Commission).

162 The customer has the option of using or not using these procedures. 7 U.S.C.A. § 7a(11) (Supp. 1, 1975), *amending* 7 U.S.C. § 7a (1970).

163 40 Fed. Reg. 54434-35 (1975). Also, counterclaims under $15,000 are permitted pursuant to proposed regulation 180.4 if the customer agrees to their submission after the counterclaim has arisen.

164 *Id.* Also, a contract market may establish, pursuant to proposed regulation 180.6 a procedure for settlement of claims and grievances involving only its members.

cedure.[165] No contract market-related appeal is allowed from the award of the arbitrators.[166]

The proposed rules prohibit prior agreements to submit claims to settlement procedures.[167] This prohibition will cause confusion regarding existing agreements and ongoing arbitration. In order to avoid this, the Commission should permit existing arbitration agreements to continue in force for their duration, or for a convenient period of time before renegotiation in accordance with the new rules.

F. *National Futures Associations*

The Act provides enabling authority for the formation, and registration, of national futures associations.[168] These are self-regulatory bodies for the futures trading industry, similar to the National Association of Securities Dealers (NASD).[169] An association applying for registration[170] must show that its registration is in the public interest, and that it meets the Commission's standards.[171] Its rules[172] must be designed to promote just and equitable principles of trade, and must provide for discipline of members.[173] The associations are subject to thorough Commission regulation.[174]

The Act provides two incentives for joining a registered futures association. First, each registrant under the Act not a member would be required to pay such fees and charges as necessary "to defray the costs of additional regulatory duties required to be performed by the Commission because such person is not a

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165 *Id.* at proposed regulation 180.2. The rules have been published for comment but have not yet been adopted by the Commission. The final rules may vary somewhat from the proposed version.

166 *Id.*

167 *Id.*

168 7 U.S.C.A. § 21 (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

169 Established pursuant to the Securities Exchange Act, 15 U.S.C. § 780-3 (1970).

170 Registrants under the Commodity Exchange Act, contract markets, and any other persons deemed eligible by the Commission would be eligible to join such an association. 7 U.S.C.A. § 21a (Supp. 1, 1975), *amending* 7 U.S.C. §§ 1-17a (1970).

171 *Id.* § 21(b)(1).

172 Its rules must include provisions relating to membership suspension, and expulsion of members, conduct of members, and arbitration procedures. *Id.* at 21(b).

173 *Id.* § 21b(3).

174 *Id.* § 21.

member of a registered futures association."[175] Secondly, nonmembers would be subject not only to the obligations and requirements of the Commodity Exchange Act imposed on other persons, but also such other requirements and obligations as the Commission found necessary "to protect the public interest and promote just and equitable principles of trade."[176]

The futures association provisions were attacked during the Congressional hearings on grounds that "the creation of such associations would be an abdication of the regulatory role to be carried out by the Commission. Such associations would create an unnecessary layer of regulation, would tend to become pressure organizations forcing all in the commodity industry to join, and could make effective regulation by the Commission more difficult."[177] Also, a major motivation for organizing national futures associations is missing, since the commodity futures industry has no equivalent to "over-the-counter" trading in the securities industry, which was an impetus for establishing the NASD.[178]

Despite such criticism, properly organized and operated associations could provide an over-burdened agency with valuable day-to-day assistance in the regulation of futures trading personnel and exchanges. They might also improve the industry's image by providing information about the exchanges, and thereby increase public confidence in the institution of futures trading.

III. Critical Issues for Commission Resolution

Congress left several critical issues for the Commission to resolve[179] during the first year of its life.[180] The Commission estab-

175 *Id.* § 21(d).
176 *Id.* § 21(e).
177 *Hearings on H.R. 11955 Before the House Comm. on Agriculture,* 93d Cong., 2d Sess. 18-19 (1974).
178 Johnson, *supra* note 2, at 41-42.
179 Aside from those discussed in this article, the most immediately significant include: (1) A determination of the types of trading records required of brokers, FCM's, contract markets and clearinghouses, 7 U.S.C.A. § 6g (Supp. 1, 1975), *amending* 7 U.S.C. § 6g (1970); (2) The establishment and maintenance of research and information programs to investigate the feasibility of trading by computer and the expanded use of modern information system technology. *Id.* § 18, *amending* 7 U.S.C. §§ 1-17a (1970); Note, *The Role of the Commodity Futures Trading Com-*

lished four Advisory Committees, and gave them the responsibility for making recommendations on these issues. These Advisory Committees have a membership drawn from industry, academia, labor, agriculture and the public. They began their initial meetings in late October and early November and will continue deliberations through part of 1976.[181]

A. *Definition of Bona Fide Hedging*

1. Explanation of Hedging

A hedge is a futures transaction or position for which the trader has an offsetting position in the cash market for the same commodity.[182] In its simplest conception, hedging appears to be a process by which a farmer, producer, or purchaser shifts the risk of price fluctuations from himself to a speculator. The hedger is a neutral trader, uninterested in speculating.[183] The purchaser of a futures contract protects himself from a price rise occurring before delivery date. The seller protects himself from a price decline. The speculator's profit or loss depends upon his ability to estimate price movements.[184]

"Arbitrage hedging"[185] is a more sophisticated concept that emphasizes expected returns rather than simply reduction of risk. The claim is that "in most circumstances hedging is merely a form of speculation — speculation on the basis.[186] The hedger differs from the speculator only because the variation in his out-

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mission Under the Commodity Futures Trading Commission Act of 1974, 73 MICH. L. REV. 710, 739-43 (1975); (3) An investigation and report to Congress not later than June 30, 1976, on the need for legislation providing insurance against losses caused by the financial failure of futures commission merchants, Pub. L. No. 93-463, 88 Stat. 1415.

180 The deadlines established by the Act for Commission resolution of several of these issues were extended by Pub. L. No. 94-16, 89 Stat. 77.

181 40 Fed. Reg. 32866 (1975).

182 TEWELES at 33.

183 Note, *Abuse in the Commodity Markets: The Need for Change in the Regulatory Structure*, 63 GEO. L.J. 751, 767 (1975) [hereinafter cited as THE NEED FOR CHANGE]; JOHNSON at 30-31; TEWELES at 33; HIERONYMOUS at 105.

184 THE NEED FOR CHANGE, *supra* note 183 at 769.

185 TEWELES at 36.

186 "Basis" is the difference beween the current price of the cash commodity and the price of a designated future contract for that commodity.

come is generally less. What the hedger accomplishes is the specialization in risk, not the elimination of it."[187]

"Selective" hedging and "anticipatory" hedging interpret the hedging process in terms of expectation.[188] Selective hedging is partial hedging based on the hedger's subjective determination of price movement during a given period.[189] If he expects a price decline, he will hedge all of his inventory, but may hedge none of it if he expects a price increase.[190] Anticipatory hedging is purchasing or selling futures in anticipation of a formal merchandizing commitment to be made later and carrying an open position in the futures market without an offsetting cash commitment.[191]

Many economists now believe that hedging contains a significant speculative element. They reject the idea that hedging is purely a risk-shifting device that affords the commercial operator price protection and leaves him unaffected by and uninterested in price levels.[192] Commercial traders hedge for at least four reasons, and reduction of business risks is the least important.[193]

2. The Commission's Task

The Commission's definition of the term "bona fide hedging"[194]

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187 TEWELES at 35.

188 *Id.* at 36.

189 *Id.*

190 *Id.*

191 *Id.* at 37.

192 *Id.* at 35; THE NEED FOR CHANGE at 767; HIERONYMOUS at 147-50; 52 AM. ECON. REV. 431, 440-42 (1962); Working, *Futures Trading and Hedging*, 43 AM. ECON. REV. 314, 320 (1953).

193 Working, *Hedging Reconsidered*, 35 JOURNAL OF FARM ECONOMICS 560-61 (1953); TEWELES at 32-43.

194 The Commission has adopted an interim definition which generally follows the definition promulgated by the Secretary of Agriculture pursuant to 7 U.S.C.A. § 6a(3) and has given notice of its intent to adopt a permanent rule after receiving the recommendations of its Advisory Committee on the Economic Performance of Contract Markets. Their recommendations will probably be submitted to the Commission in early 1976. In the meantime, the Commission has decided not to impose speculative limits on the newly regulated commodities because of the special problems presented by these commodities. 40 Fed. Reg. 48688 (1975).

For the Commission's recently adopted interim definition, *see* 40 Fed. Reg. 48689 (1975).

In formulating its more permanent definition of bona fide hedging, the Comwill be extremely important for two reasons. First, the Commodity Exchange Act provides that speculative trading limits established by the Commission "shall not apply to transactions or positions which are shown to be bona fide hedging transactions or position as such terms . . . [are] defined by the Commission."[195] Second, the definition will be the basis for accumulating statistics on hedging in the markets. The industry, the public, and the Commission will find these statistics useful in judging the economic utility of the respective contract markets.[196] The Commission established the Advisory Committee on the Economic Performance of Contract Markets to research and recommend a definition.[197]

The purpose of establishing trading or speculative limits is to diminish, eliminate or prevent "excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity."[198] The primary object

mission is also authorized to define the term "international arbitrage." 7 U.S.C.A. 6a(1) (Supp. 1, 1975), *amending* 7 U.S.C. § 6a (1970). The CFTC Act provides that the Commission may exempt from speculative trading limits "transactions normally known to the trade as 'spreads' or 'straddles' or arbitrage." Furthermore, it provides that "the word 'arbitrage' in domestic markets shall be defined to mean the same as 'spread' or 'straddle'." *Id.*

A "spread" is the purchase of one futures contract against the sale of another contract in a different future, a different commodity, or a different market or the price difference between two futures in the same or different markets.

A "straddle" is the usually simultaneous purchase of one futures month and the sale of another either in the same or different commodity or exchange.

195 7 U.S.C.A. 6a(3) (Supp. 1, 1975), *amending* 7 U.S.C. § 6a (1970).

196 40 Fed. Reg. 34628 (1975).

197 40 Fed. Reg. 32866 (1975). The Committee will be studying the legitimate commercial uses of futures contracts in arriving at its recommended definition of bona fide hedging. It will also assess the need for and the effectivesess of position and trading limits in eliminating or preventing the "excessive speculation" which is proscribed by the Commodity Exchange Act.

A "position" is to be either "long" (having bought one or more future contracts) or "short" (having sold one or more future contracts) in the market. A position limit is the number of future contracts one can hold under the rules previously established by the Commodity Exchange Authority and now established by the Commission.

The "trading limit" is the maximum price movement, up or down, permitted on one trading session under the rules of an exchange.

198 7 U.S.C. § 6a (1970). The Commission's jurisdiction is predicated on the assumption that such speculation creates a burden on interstate commerce.

of such regulation is to assure that commodity futures prices are established by the forces of supply and demand in a competitive environment. Restraints must certainly affect anyone who upsets that mechanism, whether he bears the name of hedger or speculator.[199] On the other hand, the Commodity Exchange Act requires that the Commission set speculative limits only if there is "excessive speculation" in the trading of a commodity. Moreover, the Commission may not have to establish limits if it believes that such limits will not effectively curb excessive speculation.

Some commentators claim that speculators, who are subject to speculative limits, are at a disadvantage vis-a-vis the large commercial operators, who can take large positions under the guise of hedging and are restricted only by the bona fide hedging requirement and the anti-manipulation provisions of the Commodity Exchange Act. Therefore they claim that the commercial operators can manipulate the market, because the speculators are the only force that can effectively counter their influence.[200] Beyond this, hedgers do have two advantages over speculators. First, their margin requirements are considerably less.[201] Second, they can obtain loans to cover margins more easily than speculators.

The Commission could use two distinct approaches in deciding whether to impose speculative limits. First, it may assume that

199 Speculative limits are set in order to limit those trades and positions which affect price because of their size. Trades are "large" relative to the size of the futures market, the liquidity of the market, and the deliverable supply of the cash commodity. The Commodity Exchange Commission first established such limits in 1937. Today, CEC limits apply to ten commodities and exchange-set limits apply to eighteen others. There are no speculative limits for most of the commodities brought under regulation by the CFTC Act in 1974.

A recent CEA staff study showed that speculative limits established in the past by the Commodity Exchange Authority were determined more by subjective than empirical data. Speculative limits were set near the outer limits of the observed distributions of speculative positions and daily trades. Only the largest market participants' activities were constrained. The market was still allowed to adjust to changes in supply and demand, providing the liquidity hedgers needed. The CEA set both trading and position limits at the same level as speculative limits. Those exchanges which established their own speculative limits, however, generally did not adopt this policy. They either set trading limits which were higher than position limits, or they placed no limits on trading. *See* Report For the Commodity Futures Trading Commission: Speculative Limits, Project #201-d, CFTC Program Study Group, March 21, 1975 (Exhibit D).

200 THE NEED FOR CHANGE 764.

201 *See* TEWELES at 41.

the Commodity Exchange Act is aimed at excessive speculation per se, and formulate rules to limit it. Second, the Commission may assume that the legislature intended to strike at unreasonable price changes resulting from monopolistic activities or practices, whether speculative or not, and draft the rules to prevent such market power.

The first approach suggests that only speculators acting "excessively" cause unreasonable price changes, and that hedgers do not. Further, it assumes that individual activity is relevant only to the speculative sector of the market.

The second approach assumes that the activities of hedgers and speculators can have equally monopolistic effects. The Commodity Exchange Act exempts hedgers from speculative limits. Therefore, any limit on hedgers would require an amendment, or alternatively, an interpretation of the mandate that hedging be conducted in an orderly manner, that allows some control over hedgers.

B. *Option Trading*

A commodity option is a right to buy or sell a futures contract of a specified commodity within a prescribed time period. The option specifies the time period in which the right must be exercised, the price of the futures contract, and the price of the right (the premium). There are two important and distinguishable types of options: conventional or secured options and naked options. The principal difference is that a conventional option is guaranteed by a clearinghouse[202] while a naked option is not.

The issuer of a secured option backs his option either by owning sufficient commodity stock to cover it, or by taking a similar position in the futures market. These secured options are usually purchased by one of a small group of highly sophisticated, large investors familiar with the commodity option market. The seller of a naked option, on the other hand, neither backs his sale nor sells on an organized exchange. Naked options

202 The clearinghouse also holds the premium until the option is exercised or has expired. *Hearings on H. 13113 Before the House Comm. on Agriculture,* 93d Cong., 2d Sess. at 177 (Statement of Maurice Stockdale, Director, International Commodities Clearing House Limited, London, England).

represent nothing more than the seller's unsupported promise to perform.[203] Naked option contracts dealers seek out the small investors whose lack of familiarity with that market makes them targets for unscrupulous dealers.[204] Trading in unsecured options amounts to a bet by the seller that the customer will be wrong. If the customer is wrong, the seller "earns" the fee which he charged for writing the option. If many of the customers are right, the seller may be unable to meet his obligations.[205]

The legislative history of the Act clearly indicates that Congress intended the Commission to act promptly to prohibit trading in unsecured options.[206] Such trading has been a major financial scandal in recent years.[207] However, there are conceptual difficulties in defining naked options and crafting a prohibition that will

203 Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 211 (1973) [hereinafter cited as LONG].

204 *Id.* at 222. Because of these pernicious dealings, option transactions have recently been the subject of litigation in several states. In some cases it appears that no distinction has been made between naked options and London options. *See, e.g.*, Clayton Brokerage of St. Louis, Inc. v. Roy W. Mouer, Securities Commissioner of Texas, No. B-5238 (Tex. Sup. Ct., Feb. 26, 1975). It also appears that there may be a direct conflict between state and CFTC jurisdiction to regulate commodity option transactions. *See, e.g.*, State of Texas v. Monex International, Limited, COMMODITY FUTURES L. REP. ¶ 20,083 (11th Sup. Jud. Dist. 4770, Aug. 29, 1975). The State of Texas has applied for writ of error to the Texas Supreme Court in the Monex case. The CFTC recently sought to enjoin allegedly illegal option transactions in Georgia and California. The Commission's first injunctive action was filed in the U.S. District Court in Los Angeles against the American Options Corporation of Salt Lake City, Utah, and three of its officers. The Commission's complaint charges the defendants with violations of antifraud and commodity trading advisor provisions of the Act. (CFTC Release No. 60-75, October 6, 1975). The Commission's second injunctive action was filed in the U.S. District Court in Atlanta against the American Overseas Trading Corporation and Roy Potochnik, its principal officer, asking the court to restrain the defendants from deceiving, defrauding, or cheating public investors in offers and sales of commodity options and commodity futures contracts through false and misleading statements regarding the sale of London options. The court has issued a preliminary injunction restraining the defendants from further commodity trading advisory activity. (CFTC Release No. 63-75, Oct. 10, 1975; CFTC Release No. 64-75, Oct. 16, 1975).

205 CFTC, REPORT ON PUT AND CALL TRADING 3 (1974) [hereinafter cited at PUT AND CALL TRADING].

206 HOUSE REPORT at 31; SENATE REPORT at 26. For a discussion of naked options, *see* LONG, *supra* note 268; *see also* Cal. Corp. Comm. Release No. 29-c, 1 BLUE SKY L. REP. 6879 (Feb. 8, 1973); DUN'S, Mar. 1973 at 72.

207 The failure of the Goldstein-Samuelson firm in California cost the public an estimated $45 million. The Attorney General of the State of New York in October, 1974, charged that the failure of the firm of Collins and Day caused a loss to the public of over $2.5 million. Both of these firms were dealing in naked options. PUT AND CALL TRADING 2-3.

not cover secured options as well. For the logical extension of the argument that options not covered by physical inventories of commodities or futures contracts for such commodities should be prohibited, would be to require that all futures transactions by speculators be prohibited, since speculators' futures contracts are not so backed. This would not be a completely unacceptable result. After all, there is little difference between making a futures contract and purchasing the right to buy one at a later date.

Congress has avoided this conceptual difficulty in the past by prohibiting options trading in regulated commodities.[208] But to proscribe trading in all options prevents the public from taking advantage of a justifiable investment opportunity.[209] Options transactions add liquidity to the market by encouraged speculation by small investors in two ways. First, because the option holder is not required to exercise his option, his potential loss is limited to his premium payment. By contrast, the future contract holder's loss is limited only by the magnitude of adverse price movements. Option trading thus allows the speculator with limited venture capital[210] to risk only that amount.

Second, the purchaser avoids exposure to margin calls,[211] because in a conventional option transaction the writer of the options bears the risk and cost of margin liability in return for the option premium.[212] This risk-shifting particularly helps small speculators who, although accurately predicting long-run price movements, are caught by temporary adverse price fluctuations and lack the venture capital to meet the margin calls. Currently, from two to twenty-five percent of all speculators show net gains;

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208 7 U.S.C. § 6 (1970). The CFTC Act continues the ban on trading in commodity options in the commodities formerly subject to regulation. 7 U.S.C.A. § 6c (Supp. 1, 1975), *amending* 7 U.S.C. § 6c (1970). Option trading in other commodities is permitted in the absence of any prohibitory Commission rule or order. The Commission may expressly allow such transactions, and prescribe the conditions for trading. *Id.; see* Note: *Federal Legislation for Commodity Option Trading: A Proposal,* 47 S. Cal. L. Rev. 1418 (1974). Options are also referred to as privileges, indemnities, bids, offers, puts, calls, advanced guaranties, and decline guaranties.

209 *Hearings on H. 13113 Before the House Comm. on Agriculture,* 93d Cong., 2d Sess. at 175 (Statement of Lester M. Abbott).

210 Venture capital is the money a speculator can risk losing without making drastic changes in his lifestyle (such as having to mortgage his home, take an extra job, etc.).

211 *Id.*

212 *Id.* at 176.

if option trading were allowed, this might increase to fifty to sixty percent.[213] Such increase would be directly attributable to the speculator's new ability to wait out temporary adverse price movements.[214]

By changing the focus of its inquiry from the nature of the option to the manner of trading, the Commission can reconcile the demand to prohibit naked options with the need to allow public trading in options. Options abuses stem from the fact that they are granted by persons not dealing in the futures market. Thus, the regulation of options transactions should focus on the persons and exchanges involved, not on the grantor's physical stocks or his market position. Only in a recognized futures market, such as the London exchange,[215] where a futures contract is in fact delivered against every option and all options are guaranteed, are options not "naked."

The Commission is considering several solutions to the problem:[216] (1) to prohibit all transactions in commodity options; (2) to restrict option transactions to contract markets; (3) to prohibit option transactions except in accordance with a business plan approved by the Commission; (4) to prohibit naked options; and (5) to permit only futures commission merchants to conduct options transactions.

There are advantages and disadvantages to all of these solutions. To prohibit all options transactions would bar even legitimate transactions which serve desirable economic functions, and would adversely affect enterprises currently offering commodities options.

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213 *Hearings on H. 13113 Before the House Comm. on Agriculture,* 93d Cong., 2d Sess. 278 (Statement of William Morgan).

214 *Id.*

215 The London exchanges have traded commodity options for many years. *See generally,* Statement of Maurice Stockdale, Director, International Commodities Clearing House Limited, London, England, before the House Committee on Agriculture, Jan. 30, 1974. Each London option relates to an actual futures contract and becomes an actual futures contract if exercised. There is no separate option market in England. Writers of London options are frequently producers or users of commodities who are more readily able to write options because they have physical stocks. *Id.*

216 The Commission has approached this inquiry by requesting recommendations from its Advisory Committee on Definition and Regulation of Market Instruments. 40 Fed. Reg. 49360-62 (1975). The Commission has already adopted a rule broadly prohibiting deceptive acts and practices in connection with commodity option transactions. 40 Fed. Reg. 26504-06 (1975).

To permit commodity options to be sold only through Commission-regulated contract markets would assure adequate safeguards but would eliminate legitimate enterprises that could not convert to working through contract market facilities. To require the submission of business plans for Commission approval would be a direct and effective regulatory measure but would require an expensive commitment of time, personnel and resources to administration. To prohibit naked options without prohibiting legitimate options transactions would require the Commission to define "naked options." Moreover, the Commission might still need to promulgate regulations for legitimate option transactions and to continue investigations to assure compliance. Finally, to require those who engage in commodity option transactions to register as futures commission merchants would enable the Commission to insure compliance with the fiduciary standards of the Commodity Exchange Act, but those standards may not be appropriate for both types of activity. Thus, the Commission might have to adopt new rules or amend existing rules regarding segregation of customer funds, hedging of options and other customer protection standards.

A combination of the fourth and fifth approaches seems to be the most feasible and desirable solution, because it would allow trading in economically useful conventional options, with sufficient safeguards. "Naked options" will probably have to be prohibited because of the legislative intent and the economic problems they entail. Permitting only futures commission merchants to perform option transactions would give the commission control over the conduct of such transactions, and thus provide adequate protection for the investing public. At the same time, it would be less expensive and complicated than requiring exclusive use of contract market facilities, or requiring the filing of business plans.

C. *Dual Trading*

Within nine months after the effective date of the Act, the Commission must decide whether floor brokers and futures commission merchants should be permitted to trade for their own as well as customer accounts and, if so, the terms, conditions and circumstances under which such dual trading should take place.[217] The Act requires that the Commission consider the possible effect of its determination upon the liquidity of trading in the cash market,[218] and authorizes the Commission to make separate determinations for different contract markets where warranted.[219]

Dual trading may involve an inherent conflict of interest, such that it should be strictly regulated or prohibited completely.[220] Investigations by the Commodity Exchange Authority during the last five years reveal sufficient evidence to conclude that brokers took advantage of customers in only three instances.[221] The exchanges claim that this shows a lack of abuse. But it may only show that present record-keeping requirements were insufficient to enable the CEA and the exchanges to police trading.[222] A 1965 study by the General Accounting Office found forty-seven occurrences of questionable trading practices on one exchange during a three month period.[223] In nineteen of these, floor brokers had filled customers' orders noncompetitively by taking the opposite side of the transaction either for their own account or for their FCM house account.[224] A June, 1973, CEA management study found "some of the customer complaints processed in the investigations branch of CEA deal with allegations of 'bad fills' by floor brokers for customers."[225] It is argued that "if floor brokers were restricted to trading only for one interest, there would be less chance for a conflict of interest. As a result the market would benefit from a reduction in the number of customer complaints and from improved customer confidence."[226]

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217 7 U.S.C.A. (Supp. 1, 1975), *amending* 7 U.S.C. § 6i (1970). The Commission will be advised on how to resolve this issue by its Advisory Committee on Regulation of Contract Markets and Self-Regulation Associations. 40 Fed. Reg. 50558 (1975).

218 7 U.S.C.A. (Supp. 1, 1975), *amending* 7 U.S.C. § 6i (1970).

219 *Id.*

220 CFTC, REPORT ON DUAL TRADING BY FLOOR BROKERS AND FCM'S 2 (1974) [hereinafter cited as REPORT ON DUAL TRADING]; Letter from the Controller General of the United States to Robert Poage, Feb. 13, 1974; Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Act of 1974*, 73 MICH. L. REV. 710, 730-39 (1975) [hereinafter cited at ROLE OF THE CFTC].

221 ROLE OF THE CFTC, *supra* note 220.

222 *Id.*

223 H.R. REP. No. 963, 93d Cong., 1st Sess. 52 (1973).

224 *Id.*

225 *Id.*

226 *Id.*

The exchanges claim that strict exchange rules with severe penalties, and the high degree of competition between brokers, greatly reduces the apparent conflict of interest.[227] Moreover, dual trading by brokers and futures commission merchants accounts for much of the market participation and thereby assures adequate market liquidity, without which futures transactions become very hazardous for both public and commercial users.[228] Excessive gyrations and market fluctuations, caused by a lack of liquidity, rather than by too many speculators, would jeopardize the futures marketing system.[229]

Requiring the successful personal trader to give up trading for his customers could result in customer orders being handled and executed only by those brokers who cannot or will not trade for their own accounts. Customers would no longer be able to entrust their money to a trader who has proven his ability through successful personal trading. The number of available brokers and futures commission merchants would be diminished. This is against the public interest.

The CEA requires written time stamping of customer orders.[230] There is no such time-recording requirement for proprietary accounts.[231] Thus, it is extremely difficult to establish whether a floor broker or futures commission merchant favored himself over a customer. Such record-keeping requirements with respect to proprietary trades would protect the trading public by making it more difficult for brokers to take advantage of their customers. This would increase public confidence in the futures market.

Beyond such limited reform, the Commission should concentrate on promulgating rules for the regulation of brokers who handle discretionary accounts, since their potential for conflict of interest is especially great. One solution would be to prevent a broker from filling both his own needs and those of his customer with orders in the same contract month.

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227 ROLE OF THE CFTC, *supra* note 220 at 732.
228 *Id.* at 733.
229 *Id.*
230 REPORT ON DUAL TRADING, *supra* note 220 at 7.
231 *Id.; see* ROLE OF THE CFTC, *supra* note 220.

V. Conclusion

This landmark legislation will have a considerable impact on the entire commodity futures trading industry. Trading on futures markets has been growing at an extraordinary rate in recent years, and those markets play an increasingly important role in the nation's economy as they expand to cover additional goods and services. With the greatly increased activity in futures markets has come an increased potential for trading abuses which cause injury to the consumer, the investor and the markets themselves. Regulatory reform and strong means of enforcement have long been needed, and Congress has now provided them.

The new Commodity Futures Trading Commission has tremendous challenges to meet, particularly during the first year of its life. Since regulatory agencies are under attack from the public and from the government itself, the Commission's performance will be under careful scrutiny at all times. This may be the best assurance of responsiveness in protecting both the public interest and the institutions of futures trading.

STATUTE

AN ALTERNATIVE TO PUBLIC AND VICTIM ENFORCEMENT OF THE FEDERAL SECURITIES AND ANTITRUST LAWS: CITIZEN ENFORCEMENT

THOMAS C. CRUMPLAR*

Introduction

The purpose of the federal securities laws is to promote adequate disclosure of information needed by investors. The federal antitrust laws are designed to oppose anticompetitive tendencies in the economy. But even if these goals are accepted as worthwhile[1] and the corresponding unlawful activities are well defined, it is also necessary to determine how society should structure the securities and antitrust enforcement system to achieve the appropriate level of deterrence for minimum cost. An important but distinct issue is how best to compensate the victims of the unlawful activities which occur when deterrence fails.

The development of an efficient enforcement structure involves two problems. First, is it better to have a large penalty and few convictions, or a small penalty and many convictions?[2] Second, who should enforce the antitrust and securities laws and how should the incentives to prosecute be structured?[3] This article

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1 It should be noted that some commentators challenge the assumption that enforcement of the securities and antitrust laws is necessarily beneficial. Henry Manne, for instance, argues that insider trading promotes an efficient market and should be favored rather than prohibited. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

2 Breit & Elzinga, *Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis*, 86 HARV. L. REV. 693 (1973) [hereinafter cited as *Antitrust Penalties*].

3 Until the recent appearance of three articles, Breit & Elzinga, *Antitrust Enforcement and Economic Efficiency: The Uneasy Case for Treble Damages*, 17 J. LAW & ECON. 329 (1974) [hereinafter cited as Breit & Elzinga]; Becker & Stigler, *Law Enforcement, Malfeasance and Compensation of Enforcers*, 3 J. LEGAL STUDIES 1 (1974); and Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL

will deal primarily, although not exclusively, with the latter issue. It will be argued that using the same mechanism, the private compensatory action, for both deterrence and compensation results in failure to achieve either and has detrimental side effects as well. The discussion will center on how to legislatively modify the system of prosecution and penalties — the enforcement system — to achieve an optimal level of deterrence. However, brief attention will also be given to possible alternative compensation systems to replace the present private action for damages under the antitrust and securities laws.[4]

Public, victim, and citizen enforcement represent the three basic methods of prosecuting persons who violate the law. Before explaining their problems and advantages in detail, the use of the first two methods in securities and antitrust enforcement will be briefly described and citizen enforcement will be defined.

A. *Public Enforcement*

There are three types of action which the government uses to enforce the antitrust and securities laws:[5] criminal prosecution for fines or imprisonment,[6] injunctive actions,[7] and administra-

STUDIES 1 (1975), there had been very little critical analysis of the strengths and weaknesses of the various systems of enforcement. While the Breit and Elzinga piece contains an excellent analysis of the faults of the private compensatory action, it must be faulted for recommending total reliance on public actions without considering the potential of citizen enforcement. The Becker and Stigler article is a general discussion of enforcement incentives, with the conclusion that citizen enforcement (by nonvictim "bounty hunters") may be more efficient than public enforcement. The Landes and Posner article essentially is a rebuttal to Becker and Stigler; the authors conclude that the present mixed system of private compensatory and public enforcement may be preferable to the citizen enforcement approach.

4 The discussion of alternative compensation systems is at text accompanying notes 175-83 *infra*.

5 The government is of course a very large consumer and has the right under the antitrust laws to sue for damages. Clayton Antitrust Act § 4A, 15 U.S.C. § 15a (1970). Such activities are, however, more appropriately analyzed as a type of private compensatory enforcement than as public enforcement.

6 For securities law violations: Securities Act of 1933 § 24, 15 U.S.C.A. § 77 (Supp. Aug. 1975); Securities Exchange Act of 1934 § 32(a), 15 U.S.C.A. § 78ff(a) (Supp. Aug. 1975).

For Antitrust law violations: Sherman Antitrust Act §§ 1-3, 15 U.S.C.A. §§ 1-3 (Supp. Feb. 1975); Wilson Trust Act § 73, 15 U.S.C. § 8 (1970); Clayton Antitrust Act § 10, 15 U.S.C. § 20 (1970); Robinson-Patman Price Discrimination Act § 3, 15 U.S.C. § 13a (1970). For discussion of the maximum amounts for the fines, see note 11 *infra*.

7 Under the securities laws: Securities Act of 1933 § 20(a), 15 U.S.C. § 77k(a)

tive regulation.[8] Unfortunately, these have never proved to be particularly effective means of producing deterrence. Administrative regulation and injunctive relief deal primarily with future conduct and are of little value against massive cases of price fixing and stock manipulation.[9] Although incarceration of those corporate executives who initiated the illegal activity might prove an effective sanction, it rarely occurs.[10] Finally, the criminal fines are generally dismissed as woefully inadequate.[11]

(1970); Securities Exchange Act of 1934 § 21(e), 15 U.S.C.A. § 78u(e) (Supp. Aug. 1975). Under the antitrust laws: Sherman Antitrust Act § 4, 15 U.S.C. § 4 (1970); Wilson Trust Act § 74, 15 U.S.C. § 4 (1970); Clayton Antitrust Act § 15, 15 U.S.C. § 25 (1970).

Civil actions may also be brought for failure to file the necessary reports with the SEC, Securities Exchange Act of 1934 § 32(b), 15 U.S.C.A. § 78ff(b) (Supp. Aug. 1975), and for violations of FTC orders under the Clayton Antitrust Act § 11, 15 U.S.C. § 21(*l*) (1970).

8 The SEC's power to regulate broker-dealers, Securities Exchange Act of 1934 §§ 15(b), 15A(a), 15 U.S.C.A. §§ 78*o*(b), 78*o*-3(a) (Supp. Aug. 1975), and to suspend the trading of a particular security, *id.* § 19, 15 U.S.C.A. § 78s(a)(4) (Supp. Aug. 1975), and the FTC's power to prohibit a wide variety of practices through the cease and desist procedure, Federal Trade Commission Act § 5(b), 15 U.S.C.A. § 45(b) (Supp. Feb. 1975), are the chief examples of administrative enforcement in the securities and antitrust fields.

9 Although one very potent form of injunctive relief, divestiture, is available both for antitrust and securities violations, it is rarely used. For a discussion of the use of divestiture in antitrust enforcement, see Comment, *Increasing Community Control Over Corporate Crime — A Problem in the Law of Sanctions*, 71 YALE L.J. 280, 283-84 nn.6-7 (1961) [hereinafter cited as *Corporate Crime*].

In securities law another similar remedy, disgorging profits, is even less common. One reported instance is SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971), where the Second Circuit upheld an order requiring certain defendants to place all their illegal profits into a common escrow fund which would then be available to individual investors who could show injury.

10 3 A. BROMBERG, SECURITIES LAW: FRAUD § 10.3 (1974); *Corporate Crime*, *supra* note 9, at 291-93, 297.

11 The maximum fine under all the securities law provisions is only $10,000. *E.g.*, Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 77ff(a) (1970). Until this year $50,000 was the limit in antitrust. Sherman Antitrust Act §§ 1-3, 15 U.S.C. §§ 1-3 (1970) (this criminal fine should not be confused with the private civil treble damages recovery, see text accompanying note 14 *infra*, two-thirds of which is punitive rather than compensatory). Although the maximum has now been raised to $1,000,000 for corporations and $100,000 for individuals, *id.*, 15 U.S.C.A. §§ 1-3 (Supp. Feb. 1975), many commentators argue that even higher sanctions are necessary to deter monopolistic activities. A fine equal to 10% of gross annual sales volume is used by the European Community. Dam, *Class Actions, Efficiency, Compensation, Deterrence and Conflict of Interest*, 4 J. LEGAL STUDIES 47, 66 n.46 (1975). Breit and Elzinga suggest that a fine equal to 25% of the pre-tax profit for each year of monopolistic activity be employed. *Antitrust Penalties*, *supra* note 2, at 708-13.

B. *Victim Enforcement*

Although private parties have the right to bring an action to enjoin future conduct under both the securities[12] and antitrust[13] laws, the most common form of private action is one seeking compensatory relief. In federal antitrust law, all compensatory actions are authorized by a single provision granting any person "injured in his business or property by reason of anything forbidden in the antitrust laws" the right to sue for three times his damages.[14] Under the securities laws, an aggrieved investor has a choice of several specific provisions,[15] of which the rule 10b-5 action is the most frequently invoked.[16]

One of the most significant aspects of private antitrust or securities enforcement is the extensive use of the class action.[17] This device has proved especially attractive where the individual class member's damages are so insignificant that aggregation of claims is necessary to create a potential recovery large enough to justify litigation expenses for a representative plaintiff.[18]

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12 *E.g.*, Deckert v. Independent Shares Corp., 311 U.S. 282, 290 (1940) (suit for injunctive relief under Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1970); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546-47 (2d Cir. 1967) (suit for injunctive relief under rule 10b-5).

13 Clayton Antitrust Act § 16, 15 U.S.C. § 26 (1970).

14 Clayton Antitrust Act § 4, 15 U.S.C. § 15 (1970).

15 These include the right to bring suit for damages under rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) (promulgated under the Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970)); the Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1970); and *id.* § 11(a), 15 U.S.C. § 77k(a) (1970), as well as the right to rescission (which is basically a variant of a damage suit) under *id.* §§ 12(1), (2), 15 U.S.C. §§ 77*l*(1), (2) (1970); *e.g.*, Dickey v. Carter, 392 F. Supp. 1055 (D. Mass. 1975). Note should also be made of the 16(b) action, Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1970), which is brought either by or on behalf of the insider's corporation for all of the profit the insider made while engaged in short swing trading based on material inside information. A 16(b) action is a derivative suit which is a hybrid between victim and citizen enforcement, as the plaintiff shareholder can only recover his costs of litigation. As a shareholder, however, he does share proportionately in the damages awarded to the corporation.

16 BROMBERG, *supra* note 10, § 2.5(6).

17 See note 55 *infra.*

18 In *Eisen III*, the Second Circuit calculated that the average recovery after trebling would approximate $3.90 and noted that "[n]o claimant in the six years of the progress of the action had shown any interest in Eisen's claim." Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1010 (2d Cir. 1973), *vacated and remanded*, 417 U.S. 156 (1974). *See also* West Virginia v. Chas. Pfizer & Co., 440 F.2d 1079 (2d Cir. 1971). For a discussion of the negative impact of insignificant damages in class actions, see text accompanying notes 96-98 *infra.*

C. *Citizen Enforcement*

Citizen actions are not currently authorized under either the securities or antitrust laws. As they have been employed in other enforcement systems, however, citizen suits can be brought without regard to whether the plaintiff is injured or uniquely affected by the alleged violation. Incentives for the prosecution of such suits include civic zeal[19] and the award of litigation costs[20] or a percentage of the statutory fine.[21] Although the lack of additional economic incentives may not severely hamper the bringing of environmental suits, where there is considerable visibility and public interest,[22] use of citizen suits in the antitrust and securities area probably would require incentives substantially greater than the recovery of litigation expenses. Discussion therefore will be restricted to the *qui tam* suit, where the victorious plaintiff is entitled to receive a percentage of the fine[23] or recovery.[24]

Qui tam is an abbreviated form of the Latin phrase *"qui tam pro domino rege, etc., quam pro seipso in hoc parte sequitur"*[25] or "he who prosecutes this action as much for the king as for himself." The essence of the action is vindication of public rights by a private party. The more common form of *qui tam* action, based upon a so-called "common informer" statute, contains no

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19 After the recent Supreme Court decision in Alyeska Pipeline Service Co. v. Wilderness Soc'y, 95 S.Ct. 1612 (1975), which held that, absent a specific statutory provision, a court could not award attorneys' fees, civic zeal will have to play a greater role in many public interest suits.

20 *E.g.*, Consumer Product Safety Act § 24, 15 U.S.C. § 2073 (Supp. III, 1973); Federal Water Pollution Control Act § 505(d), 33 U.S.C. § 1365(d) (Supp. III, 1973); Noise Control Act § 12, 42 U.S.C. § 4911 (Supp. III, 1973); Clean Air Act § 304(d), 42 U.S.C. § 1857(h)(2)(d) (1970); Political Reform Act of 1974, CAL. GOV'T CODE § 91003(a) (West Supp. 1975).

21 See discussion of *qui tam* action at text accompanying notes 23-42 *infra.*

22 *But cf.* Citizen for Clean Air Inc. v. Stauffer Chemical Co., 367 F. Supp. 1040 (D. Del. 1973), where the citizen plaintiffs unsuccessfully argued that they should be awarded damages in order that they would better be able to pursue their "organizational goals." *Id.* at 1047-48.

23 The Harter Act § 5, 46 U.S.C. § 194 (1970), concerns wrongful refusal to issue bills of lading and gives an injured party up to one-half of the statutory fine. Non-injured parties, however, do not have standing.

24 *E.g.*, False Claims Act, 31 U.S.C. §§ 231-32 (1970), which concerns fraudulent government contracts and imposes a fine of $2,000 and double damages. Under this Act the private prosecutor is entitled to recover up to one-fourth of the total award.

25 3 W. BLACKSTONE, COMMENTARIES *160.

restriction regarding standing,[26] that is, anyone may sue. The plaintiff is a self-appointed public prosecutor whose reward lies in a percentage of a statutory fine.[27]

The prime reason for the development and use of *qui tam* actions was total absence of any effective system of public enforcement in fourteenth and fifteenth century England.[28] *Qui tam* actions proved especially useful in enforcing economic regulations. Most apprenticeship prosecutions were brought by informers[29] and the proportion was even higher for the sixteenth century's version of securities laws — the regulation of commodity distribution.[30] In the eighteenth century, *qui tam* prosecutions were extended to criminal laws.[31] The *qui tam* action was exported to the United States where in the eighteenth and nineteenth century it proved a valuable means of enforcing a variety of state and federal statutes. Highway nuisances,[32] pool halls,[33] and the slave trade[34] were at various times regulated by *qui tam*.[35]

Despite their usefulness, *qui tam* actions were never popular,[36]

26 Though most *qui tam* provisions allow anyone to bring an action, the standing requirements can be more restrictive. The first statutory *qui tam* action was restricted to suits brought by aggrieved parties. 2 Hen. 4, c. 11 (1400). An example of a contemporary aggrieved party *qui tam* action is the Harter Act § 5, 46 U.S.C. § 194 (1970).

27 Closely related to *qui tam* is the "popular action" where the private party gets the entire recovery. An example is a Kentucky statute which allows any private person to bring an action to recover treble the value of an illegal gambling debt under certain circumstances. KY. REV. STAT. ANN. § 372.040 (1973).

28 The second and more subtle purpose of *qui tam* was described by Mr. Hollis during a Parliamentary debate regarding the Common Informers Act, 14 & 15 Geo. 6, c. 39 (1951): "[A]t a certain time, . . . Parliament had very little confidence in the will of the Executive to enforce the law that it had seen fit to pass." 483 PARL. DEB., H.C. (5th ser.) 2092 (1951). A similar purpose seems to have been the basis for the current spate of citizen suit provisions. *See, e.g.*, NRDC v. Train, 510 F.2d 692, 699-700 (D.C. Cir. 1975) (Federal Water Pollution Control Act). See statutes cited in note 20 *supra*.

29 M. DAVIES, THE ENFORCEMENT OF ENGLISH APPRENTICESHIP, 1563-1642, 17 (1956).

30 *Id.* at 19.

31 2 L. RADZINOWICZ, A HISTORY OF ENGLISH CRIMINAL LAW 142 (1956).

32 Canfield v. Mitchell, 43 Conn. 169 (1875).

33 State v. Fillyaw, 3 Ala. 735 (1842).

34 Act of Mar. 22, 1794, ch. 11, § 2, 1 Stat. 347, *construed in* Adams v. Woods, 6 U.S. (2 Cranch) 336 (1805).

35 For other *qui tam* statutes, see Comment, *Private Prosecution: A Remedy For District Attorneys' Unwarranted Inaction*, 65 YALE L.J. 209, 222 n.71 (1955) [hereinafter cited as *Private Prosecution*].

36 See the discussion of the problems of *qui tam* actions at text accompanying notes 121-138 *infra*.

and as public enforcement became established, they faded from prominence.[37] By the middle of the twentieth century most of the major *qui tam* actions had been either abolished[38] or vitiated.[39] In recent years, however, *qui tam* has staged a bit of a comeback. The 1970 Report of the Subcommittee on Conservation and Natural Resources[40] engendered interest in its potential application to environmental protection.[41] In 1971 Congress made the first serious attempt in almost a century to expand the number of federal *qui tam* actions.[42]

The balance of this article will first discuss the problems inherent in the attempt to achieve deterrence through statutorily authorized private compensatory actions, the predominant method by which the antitrust and securities laws are enforced. It is concluded that this enforcement method should be abandoned. Second, the article explores the problems associated with a system of pure public enforcement, the most frequently suggested alternative to the present emphasis on the private compensatory action. Third, a discussion of how the *qui tam* action could be modified to avoid its historical handicaps as well as the problems inherent in private compensatory and public enforcement will be pre-

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37 Note, *The History and Development of Qui Tam*, 1972 WASH. U.L.Q. 81, 101 (1972) [hereinafter cited as *Qui Tam*].

38 In 1951 the British Parliament enacted the Common Informers Act, 14 & 15 Geo. 6, c. 39 (1951), and abolished the great bulk of pre-existing *qui tam* actions.

39 In 1943 the False Claims Act (the major federal version of *qui tam*) was significantly weakened and only narrowly escaped wholesale abolition. Act of Dec. 23, 1943, ch. 377, § 1, 57 Stat. 608, *amending* 31 U.S.C. § 232 (1940) (codified at 31 U.S.C. § 232 (1970)). One hindrance to *qui tam* actions under this Act is the jurisdictional requirement which prohibits suit where the government had access to the informer's evidence prior to the filing of the *qui tam*. In United States v. Aster, 176 F. Supp. 208 (E.D. Pa. 1959), *aff'd*, 275 F.2d 281 (3rd Cir. 1960), the plaintiff, prior to any formal filing, forwarded his information to the government. After the government declined to prosecute, he sought to pursue the action. On the defendant's motion, the court dismissed the case on the ground that it lacked the necessary jurisdiction, as the government had the information prior to the filing of suit.

40 STAFF OF CONSERVATION AND NATURAL RESOURCES SUBCOMM. OF THE HOUSE COMM. ON GOVERNMENT OPERATIONS, 91ST CONG., 2D SESS., QUI TAM ACTIONS AND THE 1899 REFUSE ACT: CITIZEN LAWSUITS AGAINST POLLUTERS OF THE NATION'S WATERWAYS (Comm. Print 1970).

41 *Qui Tam, supra* note 37, at 81-82 n.6.

42 H.R. 8355, 92d Cong., 1st Sess. (1971) (deposit of refuse in navigable waters). Another *qui tam* bill was introduced in February of 1974. S. 2373, 93d Cong., 2d Sess. (1974) (consumer protection against adulterated food).

sented. The last section includes a short discussion of alternative compensation systems.

Having demonstrated the desirability and feasibility of using *qui tam* actions in the enforcement of federal securities and antitrust law, a model statute implementing such a proposal for securities law enforcement, together with comments on individual provisions, is presented.

I. Deterrence in the Guise of Compensation

Cognizant of the present limitations on public enforcement,[43] both the public enforcers[44] and the courts[45] have actively en-

43 One major limitation is lack of manpower. Rowe, *Administration and Enforcement of the Periodic Reporting Provision of the Securities Exchange Act of 1934*, 25 Okla. L. Rev. 157, 177 (1972); *see* Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trading on a National Stock Exchange*, 16 U.C.L.A.L. Rev. 404, 411 n.38 (1969) [hereinafter cited as *Pandora's Box*]. Another is inadequate sanctions. See note 11 and accompanying text *supra*.

44 Both the SEC and the Justice Department have taken an active role in promoting the private action. The SEC filed an amicus brief in support of the first implied private cause of action, Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947), and has supported the expansion of private actions by continuing the practice. *E.g.*, J.I. Case Co. v. Borak, 377 U.S. 426, 427 (1964); Heit v. Weitzen, 402 F.2d 909, 911 (2d Cir. 1967); Affiliated Ute Citizens v. United States, 406 U.S. 128, 132 (1972). The filing of such briefs is an important part of the SEC case load. In 1973 the SEC filed 178 injunctive suits, referred 49 criminal cases to the Justice Department and participated, amicus curiae, in nine private actions. 39 SEC Ann. Rep. 170 (1973). Note should also be taken of the extensive informal encouragement of private actions. According to one U.S. Attorney, there is a tendency to advise a complaining investor to file a private action. Comment, *Punitive Damages in Implied Civil Actions Under the Federal Securities Laws: The Need for Flexibility*, 17 U.C.L.A.L. Rev. 1280, 1295-96 n.59 (1970).

Although the filing of amicus briefs is not as common a practice in antitrust cases, the Justice Department has supported private actions, filing amicus briefs in cases involving questions of "widespread significance in the area of private antitrust litigation." Bicks, *The Department of Justice and Private Treble Damage Actions*, 4 Antitrust Bull. 5, 9-10 (1959); *e.g.*, Eagle Lion Studios, Inc. v. Loew's Inc., 358 U.S. 100 (1958); Radovich v. National Football League, 352 U.S. 445, 446 (1957); Schwegmann Brothers v. Calvert Distiller's Corp., 341 U.S. 384, 385 (1951); Emich Motors Corp. v. General Motors Corp., 340 U.S. 558, 559 (1951); Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211, 212 (1951). The Justice Department also engages in significant informal encouragement of private action. Bicks, the First Assistant to the Attorney General, noted that it was common practice to allow a private plaintiff's counsel to participate in the government's consent negotiations. The government benefits from the private lawyer's expertise, and it "may pave the way for more effective economic relief in the future" for the private plaintiff. Bicks, *supra*, at 11.

45 See text accompanying notes 50-54 *infra*.

couraged the use of the private compensatory action as an alternative means of achieving deterrence. In fact, in recent years private suits have largely replaced public prosecution as the chief means of enforcing both the antitrust[46] and securities[47] laws. Private actions are significant not only in terms of their sheer numbers[48] but also in the impact they have on the strategy and conduct of public actions.[49]

In a traditional compensatory action the focus is as much upon the plaintiff as it is upon the defendant. In addition to establishing the wrong committed by the defendant, the plaintiff must be able to establish that he is without fault to some degree (or rebut the defendant's evidence to the contrary), that he has been injured, the extent to which he has been injured, and that his injury was the result of the defendant's action. Where the court is primarily concerned with deterrence, the resolution of these questions becomes secondary and there will be a tendency to

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46 Commenting on the growth of the private action in antitrust litigation, Earl Pollock, a noted member of the Illinois Bar, stated that:

> In fact, we may be witnessing almost a reversal of the traditional roles. The private antitrust remedy was designed as a supplement to the Government remedy; and it is true that in many instances (such as the Electrical Cases) Government actions have blazed the trail for subsequent private suits. But today it is at least a debatable question as to what is supplementing what.

Pollock, *Standing to Sue, Remoteness of Injury, and the Passing on Doctrine*, 32 ANTITRUST L.J. 5 (1966) (footnote omitted).

47 *See* BROMBERG, *supra* note 10, § 10.1.

48 In the decade from 1963 to 1972 over 7,000 private antitrust suits were filed in federal courts. Breit & Elzinga, *supra* note 3, at 329.

49 The rise of the private compensatory action has reached the point that the public action can be viewed as a means of facilitating subsequent private prosecution. Parasitic actions, where private parties bring suit on the basis of the government's earlier public prosecution, are widespread. For the use of judgments in prior governmental actions in private securities suits see Comment, *The Effect of SEC Injunctions in Subsequent Private Damage Actions — Rachael v. Hill*, 71 COLUM. L. REV. 1329 (1971). *E.g.*, Cannon v. Texas Gulf Sulphur Co., 53 F.R.D. 216 (S.D.N.Y. 1971), and Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970), were based on SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

The threat of a subsequent private suit has a great effect upon the defendants as well as upon the public prosecutor, as is evidenced by the great propensity of alleged violators in antitrust prosecutions to agree to *nolo contendere* pleas, which cannot be raised in subsequent private litigation. In at least one case the government vigorously opposed the acceptance of such pleas in part to prevent the major deterrent impact of public prosecution — the promotion of private suits — from being compromised. *Corporate Crime*, *supra* note 9, at 284 n.15.

dilute them. In antitrust and securities law, this is evidenced by the judicial treatment of these conventional elements of liability. Deterrence-oriented courts, for instance, have increasingly tended to disregard the culpability of the plaintiff and limit their consideration to the guilt of the defendant — the only issue when the goal is deterrence — by relaxing the defense of *in pari delicto*.[50] Similarly, the plaintiff in an antitrust treble damage action has been allowed to recover even though he has been able to negate or minimize the effect of a defendant's illegal overcharge by "passing it on" to his customers.[51] Even in those antitrust cases where the court requires that some injury be shown, the plaintiff is excused from proving his damages with any degree

50 *In pari delicto* means that one is equally as culpable or at fault as another party. BLACK'S LAW DICTIONARY 898 (4th ed. 1968). The most instructive example of the lack of concern with illegal plaintiff behavior in the securities field is Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971), where an attorney sued a broker with whom he had entered into a contract he knew was illegal. The Second Circuit dismissed the argument that such an unworthy plaintiff should not recover, stating:

> In our view the danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission.

Id. at 1141. *See* Carpenter v. Hall, 311 F. Supp. 1099, 1106 (S.D. Tex. 1970) (recovery should lie as long as the plaintiff's participation in the illegality is no greater than the defendant's). *Contra,* Kuehnert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

In antitrust law, the *in pari delicto* doctrine was firmly laid to rest in Perma Life Mufflers Inc. v. International Parts Corp., 392 U.S. 134 (1968), where the defendant pointed out that the plaintiff had participated in the illegal franchise agreement. Justice Black responded by noting that though the plaintiff "may be no less morally reprehensible than the defendant, . . . the doctrine of *in pari delicto,* with its complex scope, contents, and effects, is not to be recognized as a defense to an antitrust action." *Id.* at 139-40.

51 For the first 70 years of antitrust enforcement (1890-1960), the courts held firm to the compensatory basis of the private action and ruled that passing on was a valid defense. In Keogh v. Chicago & N.W. Ry., 260 U.S. 156 (7th Cir. 1922), Justice Brandeis held that, since the plaintiff manufacturer was able to pass on the added costs of allegedly fixed railroad freight rates, its damages were purely speculative. *Id.* at 165.

However, the passing on defense was eventually rejected in Commonwealth Edison Co. v. Allis Chalmers Mfg. Co., where the court stated that "to apply the pass-on defense in these circumstances would be tantamount to immunizing defendants from liability" and that this "would frustrate the purposes of the antitrust laws" and destroy "[t]he deterrent effect inherent in private treble damage actions" (even though this allowed the plaintiff to recover four times the overcharge) 335 F.2d 203, 208 (7th Cir. 1964).

of certainty.[52] Also because of the tension between deterrence and compensation, the reliance requirement is no longer an important obstacle to recovery in private anti-fraud suits under the securities laws.[53] Part of the haphazard judicial extension of civil liability under rule 10b-5 was the decline of the doctrine of privity (the requirement that plaintiff and defendant have a contractual relationship with each other).[54] The trend has been especially preva-

52 As the Supreme Court stated in Bigelow v. RKO Pictures, Inc.: "'The constant tendency of the courts is to find some way in which damages can be awarded where a wrong has been done. Difficulty of ascertainment is no longer confused with right of recovery' for a proven invasion of the plaintiff's rights." 327 U.S. 251, 265-66 (1946).

In Telex Corp. v. IBM Corp., 367 F. Supp. 258 (N.D. Okla. 1973), the court rejected both the plaintiff's claim of $361 million (before trebling), and the defendant's argument that any loss by Telex was due solely to its poor business practices. Instead, the judge declared that $117.5 million ($86.5 million after adjustment) was the correct figure, *id.* at 307-12, and, in the words of Professor Phillip Areeda, "came close to saying that no useful purpose would be served by explaining how he arrived at that sum." Speech by Professor Areeda, National Institute of the Corporate Trustbusters, Nov. 8, 1973, in 43 ANTITRUST L.J. 6, 7 (1973) [hereinafter cited as Areeda].

53 Although in fraud cases, proof of the plaintiff's reliance upon the defendant's statements or actions traditionally has been considered a basic element of tort liability, W. PROSSER, LAW OF TORTS 714 (4th ed. 1971), proof of individual reliance is difficult, if not impossible, in large class actions and meaningless in non-disclosure cases. Courts have circumvented the reliance requirement in various ways. Green v. Wolf Corp., 406 F.2d 291, 301 (2d Cir.), *cert. denied,* 395 U.S. 977 (1968) (reliance issue postponed to later individual trials when warranted by the facts); Harris v. Palm Springs Alpine Estate, Inc., 329 F.2d 909, 913-15 (9th Cir. 1969) (reliance ignored completely); Weisman v. MCA Inc., 45 F.R.D. 258 (D. Del. 1968); Mader v. Armel, 402 F.2d 158 (6th Cir. 1968), *cert. denied,* 394 U.S. 930 (1969) (last two cases assumed that reliance follows ipso facto from stock purchase).

After the Supreme Court's decision in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), it is likely that the reliance requirement will be subsumed in the *Texas Gulf Sulphur* definition of materiality:

> "The basic test of materiality . . . is whether a *reasonable* man would attach importance [to the omitted or misrepresented fact] . . . in determining his choice of action in the transaction in question." . . . This, of course, encompasses any fact . . . "which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities . . . ."

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (restating the definition of materiality formulated in List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), emphasis supplied in *Texas Gulf Sulphur*) (for a discussion as to how lower courts have applied *Affiliated Ute,* see Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584 (1975)).

The "reasonable investor" standard is likely to be interpreted broadly when a court is interested in deterrence and will be either contracted or ignored when a court is faced with unlimited damages. *See* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970).

54 *See* Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 YALE L.J. 658 (1965). Originally, privity

lent where these concepts interfere with the prosecution of class actions, which have until recently been a strongly favored enforcement tool.[55]

As the courts continue to emphasize deterrence,[56] the conduct of the private plaintiff becomes less important. Although some vestiges of compensation have been retained, a strong argument can be made that the private antitrust and securities plaintiff lawyer is far more a reward-seeking bounty hunter than counsel to a bona fide victim seeking compensation. In the class action context it has been claimed that "it is the attorneys, not the class members, who are the true beneficiaries and the real parties in interest."[57]

Because the present private action, no matter how much it is judicially modified to amplify its deterrent aspects, is still inherently compensatory, it is not the most efficient means of achieving deterrence. Private compensatory actions do not readily produce the optimal level of deterrence, and their use entails significant costs such as perverse incentives, false claims, strain on the judiciary, and failure to award the real victims any relief.

A. *Nonoptimal Deterrence*

The private compensatory action may tend to promote too much deterrence. For instance, Ruder estimates that, in the cele-

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seemed to be applicable in 10b-5 cases, but the requirement was soon ignored and today it is "rarely alluded to." Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 816 (1972). It is of no relevance in situations involving a false or misleading statement, *e.g.*, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969), and in cases of non-disclosure it seems to be little more than evidentiary fact which alone is not enough to sustain a dismissal, *e.g.*, Cochran v. Channing Corp., 211 F. Supp. 239, 245 (S.D.N.Y. 1962).

55 *See* Comment, *The Impact of Class Actions on Rule 10b-5*, 38 U. CHI. L. REV. 337 (1971); Hazard, *The Effect of the Class Action Device Upon the Substantive Law*, 58 F.R.D. 307 (1973); Simon, *Class Actions — Useful Tool or Engine of Destruction?*, 55 F.R.D. 375 (1972).

56 See notes 50-54 *supra*.

57 Handler, *The Shift from Substantive to Procedural Innovations in Antitrust Suits — The Twenty-Third Annual Antitrust Review*, 71 COLUM. L. REV. 1, 10 (1971). In 16(b) suits, see note 15 *supra*, attorneys have been compensated solely for providing information. *E.g.*, Blau v. Rayette & Faberge, Inc., 389 F.2d 469, 473 (2d Cir. 1968). In such situations, the lawyer becomes almost identical to the *qui tam* plaintiff who is rewarded for information as well as for successful prosecutions. See note 61 and text accompanying note 93 *infra*; Free World Foreign Cars, Inc. v. Alfa Romeo, 55 F.R.D. 26, 30 (S.D.N.Y. 1972).

brated *Texas Gulf Sulphur* case,[58] which involved a massive violation of the securities laws, the company's liability could theoretically have totalled $390 million,[59] or $150 million more than the company's net worth.[60] Although it is fairly certain that no court would allow anything so dramatic to occur,[61] these figures indicate a problem with using compensatory actions as a tool of deterrence. Furthermore, to prevent such over-deterrence judges would have to resurrect previously discredited doctrines such as passing on,[62] reliance,[63] and privity,[64] which tend to limit the number of plaintiffs and the amount of liability. Such judicial vacillation would make it impossible to maintain a coherent body of law under which potential defendants could make decisions.[65]

The private compensatory action may also produce insufficient deterrence in some contexts. In a large class action the attorney's incentives often operate to produce a settlement at less than the socially optimal figure.[66] This incentive to settle is further height-

58 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

59 Ruder based this figure on the fact that the rescission method of damages allows a seller to recover the current value of the stock, not the value at which he sold it. The lack of privity places the limit of liability at the number of transactions during that period, not the number of shares outstanding. Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423, 427-29.

Both the traditional out-of-pocket damage rule, Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968), *modified*, 417 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970), and the privity requirement, *see* note 6 *supra*, have been rejected by the courts.

60 Ruder, *supra* note 59, at 429 n.38.

61 For a similar instance outside of the antitrust and securities areas, *see* Ratner v. Chemical Bank N.Y. Trust Co., 54 F.R.D. 412 (S.D.N.Y. 1972), which involved a class action on behalf of 130,000 Master Charge card holders for violation of the Truth in Lending Act requirement of disclosure of the annual percentage finance charge on its periodic billing. Although damages were minimal or nonexistent, the statutory $100 minimum damages figure would have resulted in an award of 13 million dollars. In order to prevent this "horrendous, possibly annihilatory punishment," the court held that a class action could not be maintained. *Id.* at 416. The attorneys were, however, awarded $20,000 for their efforts. *See generally* Note, *Class Actions Under the Truth in Lending Act*, 83 Yale L.J. 1410 (1974).

62 See note 51 and accompanying text *supra*.

63 See note 53 and accompanying text *supra*.

64 See note 54 and accompanying text *supra*.

65 See text accompanying notes 83-85 *infra*.

66 Judge Friendly, commenting on the analogous incentives in stockholder's derivative actions, stated:

The plaintiff stockholders or, more realistically, their attorneys have every ened by the fact that no single class member has a monetary stake large enough to make supervising the lawyer worth his while.[67] Although a judge traditionally provides a check in such a situation, the uncertainty of "reasonable damages" and the great desire to clear the docket operate to minimize his effectiveness.[68]

Finally, it is very difficult to regulate the number of private compensatory actions brought.[69] If a court or government agency felt there were too many or too few private actions being prosecuted, its only tool of adjustment would be carving out further exceptions to the statutory or case law. Such adjustments would take considerable time, would be far from precise, and would probably have undesirable side effects.[70]

B. *Perverse Incentives*

Perverse incentives arise when a party neglects to mitigate the harm inflicted despite the fact that the resulting damages exceed the cost of avoidance. Because an individual realizes that reparations will be forthcoming if he is found to be dealing with a securities or antitrust law violator, he will be less likely to police his transaction to minimize harm from illegal activity. The perverse incentives effect is magnified in treble-damage antitrust suits, where there is a "profit" for plaintiff in incurring more damages.

> incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be. The percentage allowance in stockholders' actions is "reduced as the amount of recovery passes the million dollar mark," . . . and a juicy bird in the hand is worth more than the vision of a much larger one in the bush, attainable only after years of effort not currently compensated and possibly a mirage.

Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (dissenting opinion) (citations omitted).

67 A lawyer can even settle a case over the objections of the representative plaintiff. 3B J. MOORE, FEDERAL PRACTICE ¶ 23.1.24[2] (2d ed. 1975); Saylor v. Lindsley, 456 F.2d 896, 899 (2d Cir. 1972) (settlement denied on ground that attorney did not fulfill obligations to plaintiff). In situations where there are several plaintiffs, lawyers may be a partial check on each other.

68 *See generally* McGough & Lerach, *Termination of Class Actions: The Judicial Role*, 33 U. PITT. L. REV. 445 (1972).

69 There is generally no requirement that the government even be given notice of filing by a private plaintiff. *Contra*, Investment Company Act of 1940 § 33, 15 U.S.C. § 80a-32 (1970).

70 Breit & Elzinga, *supra* note 3, at 347-48.

The best example of perverse incentives in the securities area arises in the *in pari delicto* situation, where a culpable plaintiff could theoretically be barred.[71] Two recent cases, *Pearlstein v. Scudder & German*[72] and *Courtland v. Walston & Co.*,[73] demonstrate that an investor can enter into an illegal transaction, smug in the knowledge that if it fails, he can recoup his losses by suing his former comrade in crime. In his dissent in *Pearlstein,* Judge Friendly alluded to the perverse incentive effect:

> Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violators inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win tails-you-lose."[74]

The antitrust case law is rife with examples of perverse incentives. In *Sun Cosmetic Shoppe Inc. v. Elizabeth Arden Sales Corp.*[75] the plaintiff alleged that Elizabeth Arden's refusal to supply it with a "demonstrator" constituted unlawful price discrimination. Judge Hand, recognizing the operative perverse incentives, stated that if the loss to Sun caused by the diversion of its customers to stores with demonstrators was greater than the cost of employing such a demonstrator, Sun was obliged to minimize its loss by hiring a demonstrator.[76] This view, however, has not been followed in subsequent cases and most courts hold that the plaintiff is under no obligation to minimize his losses.[77]

The magnified perverse incentives effect can also be seen in *American Can Co. v. Russellville Canning Co.*,[78] where the plaintiff sued the defendant on the basis of its discriminatory pricing policy. Although the plaintiff could have accepted the cans and then have sued for the overcharge, it decided to refuse delivery

71 *See* note 50 *supra.*
72 429 F.2d 1136 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971).
73 340 F. Supp. 1076 (S.D.N.Y. 1972).
74 429 F.2d at 1148 (footnote omitted).
75 178 F.2d 150 (2d Cir. 1949).
76 *Id.* at 153.
77 *E.g.,* State Wholesale Grocers v. Great Atlantic & Pacific Tea Co., 202 F. Supp. 768 (N.D. Ill. 1961).
78 191 F.2d 38 (8th Cir. 1951).

and sue for the loss of canning business. The appellate court recognized that this decision was influenced by the antitrust laws:

> Arvel Blaylock's conduct in dealing with these shipments and making claims for loss of profits was obviously strategic, and stemmed from the defendant's refusal to accede to his demand that cans be shipped to the plaintiff free of freight, as well as from his interest in enhancing his alleged damages for the purpose of this lawsuit.[79]

C. *False Claims*

False claims, the propensity of a private party to claim harm where in reality none exists, create further inefficiencies. False claims are thought to be common in personal injury cases where it is often cheaper for the defendant to settle than to go through the "nuisance" of a trial to prove his innocence.[80] In antitrust and securities class action cases, the incentives for settlement are even greater,[81] given the risk-averse nature of corporate executives and the inflated nature of the damages.[82]

The pressure to settle is exacerbated by class actions, where risks and litigation expenses are multiplied. Judge Medina, commenting on the class action suit, stated:

> There is reason to believe that the practical effect of these procedures [preliminary mini-hearing, fluid recovery, etc.], and the fact that possible recoveries run into astronomical amounts, generate more leverage and pressures on defendants to settle, even for millions of dollars, and in cases where the merits of the class representatives [*sic*] claim is to say the least doubtful, than did the old-fashioned strike suits made famous a generation or two ago by Clarence H. Venner.[83]

79 *Id.* at 55. The appellate court's reversal of the award was partially due to the plaintiff's action. Subsequent cases, however, have demonstrated that such conduct by the plaintiff would not prevent a court from awarding damages to the plaintiff. *See* the *in pari delicto* cases, note 50 *supra*.

80 Breit & Elzinga, *supra* note 3, at 340 & n.31.

81 As Dooley states:

> Few defendants will be courageous enough to run the risk of bankruptcy in the event the court dispenses with individual proof of damages and enters judgment in favor of the entire class.

Dooley, *supra* note 54, at 832 (footnote omitted).

82 See discussion of excessive deterrence at text accompanying notes 58-65 *supra*.

83 Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1019 (2d Cir. 1973), *vacated and remanded*, 417 U.S. 156 (1974) (*Eisen III*).

In a personal injury action, although the cause in fact is often difficult to ascertain, the relative clarity of standards of conduct and rules of liability serves as a check on nuisance suits. It is possible for the defendant to determine whether the plaintiff has an arguable cause of action. If the plaintiff's suit has little or no merit, the defendant may confidently refuse to settle. Although the cost of litigating such a case may outweigh the cost of settlement, repeated refusals to settle by defendants will eventually result in the cessation of such nuisance suits. However, this strategy may not always be employed because it depends on the willingness of a defendant to spend money in order to benefit future defendants other than himself.

In the fields of antitrust and securities, the law is unsettled not only with regard to the elements of liability, but also with regard to the precision with which damages must be proved.[84] There are few situations where a firm's counsel can confidently advise his client that a suit should not be settled.

The presence of juries in suits against large corporate entities may also favor the bringing of false claims. Although there is little concrete empirical data regarding jury decision, there is reason to believe that a juror will be tempted to ignore the labyrinth of legal liability and simply decide the case on emotion.[85]

Perhaps the greatest incentive to bring false claims is that, under the contingent fee system, a plaintiff often has nothing to lose if the court summarily dismisses his suit. No matter how baseless his claim, he does not run the risk of paying the defendant's costs in a 10b-5 action[86] and usually in an antitrust treble-damage suit.[87] On the other hand, if he wins, the court may require the defendant to reimburse him for his costs.[88]

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84 *See* notes 50-54 *supra*.

85 According to Thomas M. Scanlon: "In triple damage antitrust actions . . . the jury, and for that matter the court, reaches its verdict or finding motivated by emotional factors and rational factors are used only to justify the verdict or finding after it has been arrived at emotionally." Scanlon, *The Jury's Viewpoint*, 38 ANTITRUST L.J. 76 (1968).

86 BROMBERG, *supra* note 10, § 2.5(2) n.109.

87 In Bryam Concretanks, Inc. v. Warren Concrete Products Co., 374 F.2d 649 (3rd Cir. 1967), the court held that the plaintiff could not be charged with defendant's expenses even if it were demonstrated that he brought the action in bad faith.

88 Globus, Inc. v. Jaroff, 279 F. Supp. 807 (S.D.N.Y. 1968); BROMBERG, *supra* note 10, § 9.3.

In addition to antitrust treble damages, the court in Finley v. Music Corp. of

D. *Strain on the Judiciary*

The present system of private enforcement with its emphasis on class actions places a significant strain on the already overburdened court system. The complexity of these suits, not their number, is the main problem. A considerable amount of judicial time must be expended in wading through the procedural quagmire of the Rule 23 procedure. The *Eisen* case, which has gone on for over nine years without a single determination of any substantive issues,[89] is an apt illustration. Even where the suit is not a class action, the private compensatory action is an inefficient means of achieving deterrence in that considerable time must be spent determining not whether a violation of the law has occurred but whether the particular plaintiff has been harmed.

The problems with class actions have created a dilemma. Trying to accommodate such suits places a perhaps intolerable burden on the court system, but restricting their use undermines their effectiveness as a means for achieving either deterrence or compensation. Because the Supreme Court seems recently to have chosen the restrictive approach,[90] the need for alternative mechanisms of law enforcement is more apparent than ever.

America, 66 F. Supp. 569 (S.D. Cal. 1946) held that attorneys' fees could be recovered even if the plaintiff's inadequate proof of damages barred it from any other recovery.

89 The first round began in 1966, Eisen v. Carlisle & Jacquelin, 41 F.R.D. 147 (S.D.N.Y.). The recent Supreme Court decision, 417 U.S. 156 (1974), which dealt solely with the question of class notice, left open the possibility of more litigation as the court expressly allowed Eisen to redefine the class. *Id.* at 179, n.16. *See* Weinstein, *Some Reflections on the "Abrasiveness" of Class Actions*, 58 F.R.D. 299 (1973).

90 Zahn v. International Paper Co., 414 U.S. 291 (1973); Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974). *Zahn* limits the FED. R. CIV. P. 23(b)(3) class action by requiring each member of the plaintiff class having a separate and distinct claim to meet the jurisdictional minimum amount. In areas of federal question jurisdiction exempted from jurisdictional amount requirements, this will have no effect, but where there is an amount in controversy requirement, it will require careful definition of the class to insure that each plaintiff can meet the jurisdictional minimum. *Eisen* interpreted rule 23(c)(2) to require that individual notice be sent to all class members whose names and addresses can be ascertained through reasonable effort, and that the plaintiff must bear the cost of notice to members of his class as part of the ordinary burden of financing his own suit. This will effectively prevent maintenance of a class action where individual damages are too small to bear the cost of an individual suit. For a discussion of the cases see Note, *Managing the Large Class Action: Eisen v. Carlisle & Jacquelin*, 87 HARV. L. REV. 426 (1973); Note, *Class Actions and the Need for Legislative Reappraisal*, 50 NOTRE DAME LAWYER 285 (1974); Comment, *Zahn v. International Paper: Taking the Action Out of Class Action, or Can Zahn be Avoided?*, 12 SAN DIEGO L. REV. 208 (1974).

E. *Failure to Compensate*

The high cost of a private compensatory deterrence system might be tolerable if compensation were really achieved. There is strong evidence, however, to indicate that it often is not. In many cases only a small portion of the judgment ever reaches the victims.

One problem is that securities and antitrust litigation, especially where it involves class actions, is enormously expensive. Attorney fees consume a large portion of any damage award. In *Trans World Airlines v. Hughes*[91] the attorneys' fees alone were 7.5 million dollars.[92] In a proposed settlement of a Master Charge antitrust suit, where the alleged damages exceeded 10 million dollars, the terms provided that no compensation was to be awarded to class members. All funds were to be used to pay attorneys' fees and notice costs.[93] There have been at least two court-sanctioned settlements under the Truth in Lending Act where only attorneys' fees were awarded, despite the fact that the alleged damages exceeded 10 million dollars.[94]

Judicial attempts to provide some kind of a check on excessive fees have met with little success. In *Farmington Dowel Products Co. v. Forster Manufacturing Co.*,[95] the First Circuit reversed the trial judge's attempt to set 50 percent of the treble-damage award as the maximum figure for an attorney's award on the ground that the limitation was not justified.

Even if attorneys' fees presented no problem, there would still be no guarantee that the damage awards would ever reach the injured parties. *Market Street Railway v. Railroad Commission*[96] is but one case which illustrates the apathy or ignorance of class

91 312 F. Supp. 478 (S.D.N.Y. 1970) *aff'd*, 449 F.2d 51 (2d Cir. 1971), *rev'd on other grounds*, 409 U.S. 363 (1972).

92 *Id.* at 485.

93 Wall Street Journal, Dec. 8, 1971, at 13, col. 1.

94 Ratner v. Chemical Bank N.Y. Trust Co., 55 F.R.D. 412, 416 (S.D.N.Y. 1972); Schlachet v. Interbank Card Ass'n, No. C 71-711 (N.D. Ohio 1971); *see* Davenport, *Class Suits Against Banks: The Lingering Specter*, 89 BANKING L.J. 787 n.1, 798-99 (1972).

95 436 F.2d 699 (1st Cir. 1970).

96 28 Cal. 2d 363, 171 P.2d 875 (1946). In Eisen III, 479 F.2d 1005, 1010 (2d Cir. 1973), *vacated and remanded*, 417 U.S. 156 (1974), the court noted that no potential claimant in the six years of the action had shown any interest is prosecuting his claim.

members.[97] A noted plaintiff's attorney, Abe Pomerantz, has commented on this phenomenon:

> Either inertia . . . or the often difficult task of gathering up proofs of claim, tends to make the injured class member unwilling or unable to pick up his share of the recovery effected by the volunteer plaintiff.[98]

There are also judicial barriers to victim recovery. Two decisions have held that a utility may bring an antitrust action against a seller from whom it has purchased regardless of passing on,[99] while its customers have no action against the defendant due to lack of privity.[100] The result of these decisions is that "the only party who was actually injured (*i.e.*, the utility's customer) has no remedy and the only party who has a remedy (*i.e.*, the utility) was not actually injured."[101]

The problems of private compensatory actions under the securities and antitrust laws, especially as they involve the class action, have provoked considerable criticism from judges,[102] commentators,[103] and the organized bar.[104] The rising chorus of disapproval is also reflected in recent Supreme Court decisions which create significant obstacles to the use of class actions as a means of achieving deterrence.[105] If the private compensatory action is not capable of efficiently producing deterrence, what method of enforcement should be substituted in its place — pure public enforcement or another form of private prosecution? Can an improved enforcement system be combined with a compensation

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97 Pomerantz, *New Developments in Class Actions — Has Their Death Knell Been Sounded?*, 25 Bus. Law. 1259, 1261 (1970) (only two percent of the class presented claims).

98 *Id.* at 1260.

99 Commonwealth Edison Co. v. Allis Chalmers Mfg. Co., 335 F.2d 203 (7th Cir. 1964). For a discussion of passing on, see note 51 *supra*.

100 Commonwealth Edison v. Allis Chalmers Mfg. Co., 315 F.2d 564 (7th Cir. 1963).

101 Pollock, *supra* note 46, at 16.

102 Eisen v. Carlisle & Jacquelin, 391 F.2d 555, 571-72 (2d Cir. 1968) (dissenting opinion of Judge Lumbard).

103 *See* Breit & Elzinga, *supra* note 3; Ruder, *supra* note 59, Handler, *supra* note 57.

104 American College of Trial Lawyers, Report and Recommendations of the Special Committee on Rule 23 of the Federal Rules of Civil Procedure (1972).

105 *See* note 90 *supra*.

scheme which provides real relief to victims without distorting efforts at deterrence?[106]

II. Critique of Total Public Enforcement

The alternative most frequently suggested by the critics of the compensatory action is exclusive reliance on public prosecution.[107] They argue that the abolition of the private compensatory action combined with a general increase in the "bite" of criminal fines and other sanctions available to the public prosecutor would result in a far better enforcement system. Total reliance on public enforcement would, however, exacerbate the problems of objectionable prosecutorial incentives and budgetary restraints.

A. *Prosecutorial Incentives: Non-action*

Posner, in his discussion of the FTC role in anti-trust enforcement,[108] lists job retention and the desire to obtain greater appropriations for one's agency (as a way of increasing personal power) as the prime bureaucratic incentives.[109] Such incentives are not conducive to the most efficient system of enforcement. Posner argues that:

> The self-interest of such individuals would appear to dictate the avoidance of controversy and the conciliation of well organized economic interests and influential Congressmen. Such policies are inconsistent with the determined and effective pursuit of consumer interests.[110]

The Vesco[111] and ITT[112] cases are apt examples of political con-

106 See discussion of alternative compensation schemes at text accompanying notes 175-183 *infra.*

107 Breit & Elzinga *supra* note 3, at 345-48; *Corporate Crime, supra* note 9, at 297-305.

108 Posner, *The Federal Trade Commission,* 37 U. Chi. L. Rev. 47 (1969).

109 *Id.* at 85.

110 *Id.* at 85-86. Despite such problems with public enforcement, Posner has concluded that the present system may be preferable to bounty hunter-type enforcement, at least where investigation costs are high. Landes & Posner, *supra* note 3, at 30.

111 Among the allegations filed against Richard Nixon in the impeachment debate in the House Judiciary Committee were the "[s]olicitation of a $200,000 campaign contribution by financier Robert L. Vesco" and "[p]referential treatment by Justice and the Securities and Exchange Commission in return for political support . . ." Burby, *Impeachment Report/Judiciary Committee Ponders 'Question of High Privilege,'* 6 Nat'l J. Rep. 724 (1974) [hereinafter cited as *Impeachment*].

112 In the Nixon impeachment hearings, it was alleged that "[a]n antitrust suit

siderations hindering public prosecution. Even apart from cases of blatant political pressure it is well recognized that many agencies tend to become solicitous of the industry they regulate and decline to pursue a policy of vigorous enforcement.[113]

The tendency to decline bona fide suits is a direct result of another prime prosecutorial incentive — the maintenance of a high conviction rate. Such pressures may cause a public official to avoid the important but difficult case when the probability of conviction is less than the going office rate. This hesitancy is especially prevalent in the securities field, where the cases involve a great number of victims and complex legal issues. "As might be expected, U.S. Attorneys do not express great enthusiasm for such referrals [of criminal prosecutions under the securities laws]; indeed, the common reaction was that a big SEC case would play havoc with the operations of the office."[114] Even in such districts as the Southern District of New York, where SEC cases are commonplace, perverse incentives operate. There is a natural incentive to accept consent judgments which entail less effort but show up on the plus side of the conviction rate. Such agreements, however, weaken the deterrent effect of detection and thus may harm the overall enforcement of securities laws.

B. *Abuse of Public Prosecution*

Total reliance on public prosecution would require a possibly unhealthy increase in the power of the state. The attempt by the Nixon White House to subvert the IRS enforcement mech-

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against ITT . . . was settled in return for a company pledge of financial [campaign] help in 1972 . . . ." *Id.*

113 *See, e.g.*, Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972). There the SEC had declined to challenge a proxy solicitation on what the court characterized as "a very dubious legal theory." *Id.* at 674. Even worse, the SEC was probably guilty of giving the violator, not the victim, the benefit of the doubt, thereby reversing congressional priorities. *Id.* at 672. Cognizant of the operative bureaucratic incentives, the court characterized the refusal to prosecute as:

> [A]nother manifestation of the venerable bureaucratic technique of exclusion by attrition, of disposing of controversies through calculated nondecisions that will eventually cause eager supplicants to give up in frustration and stop "bothering" the agency.

Id. at 674.

114 Rabin, *Agency Criminal Referrals in the Federal System: An Empirical Study of Prosecutorial Discretion*, 24 STAN. L. REV. 1036, 1049 (1972).

anism[115] demonstrates that malicious public prosecution may exist;[116] the capacity, if not the temptation, of the government to coerce its opponents would be greatly increased if public enforcement expanded to take the place of the private compensatory action.[117]

C. *Budgetary Restraints*

Breit and Elzinga argue that the optimal level of enforcement can be more readily reached with pure public enforcement, as the level of public prosecution is more adjustable:

> [T]he antitrust authorities could adjust policy through marginal increments in the amount of investigatory and litigative activity permitted. Under public enforcement of the antitrust laws the optimal combination of probabilities and punishments would more readily be approximated. Under a private actions approach, on the other hand, it is unlikely that such an outcome could be obtained. The amount of resources devoted to the apprehension and conviction of violators could only be changed through the use of the blunt instruments of congressional legislation, or court decisions which could ease or hinder the bringing of private actions. With public enforcement, however, a change in total antitrust activity could be accomplished with only a change in the congressional appropriations for these agencies and in the discretionary use to which the antitrust authorities put these resources. This policy (permissible only through public actions) would thus entail antitrust enforcement that would be faster and more predictable.[118]

The principal problem with this argument is the assumption that congressional appropriations will readily match the optimal

115 In the Nixon impeachment hearings, there were "[c]harges that the [Nixon] White House tried to use the Internal Revenue Service to harass 'enemies' of the Administration and be lenient with 'friends.'" *Impeachment*, note 111 *supra*.

116 Although malicious private prosecution is probably more common than governmental abuse, it should be pointed out that, given the traditional doctrine of sovereign immunity, victims of private prosecution have a greater chance of being compensated. *See* Becker & Stigler, *supra* note 3, at 15.

117 The fear of government power was the principal reason why public prosecution and law enforcement were so late in developing. *See generally* Radzinowicz, note 31 *supra*.

118 Breit & Elzinga, *supra* note 3, at 347-48.

amount of enforcement.[119] It is doubtful that Congress has either the ability or the will to engage in Breit and Elzinga's fine tuning. Nor can one take comfort in the suggestion that the fine tuning be placed within the discretion of the antitrust and securities agencies. Such discretion requires generous funding, which the securities and antitrust authorities have never received.[120]

Even assuming that the level of resources, both public and private, currently devoted to antitrust and securities enforcement is optimal, it seems unlikely that Congress would be willing to appropriate to the enforcement agencies enough additional money to offset the loss of deterrence which would result from the abolition of private compensatory actions.

III. Reform: Qui Tam

In view of the numerous problems with both private compensatory enforcement and total public enforcement, the application of the *qui tam* action to antitrust and securities enforcement merits investigation. However, any proposal to expand the use of the *qui tam* action to replace statutory private compensatory actions must also overcome the problems traditionally associated with it and include an alternative means by which victims can obtain compensation.

A. *Problems with the Qui Tam Action*

1. The Informer's Negative Image

One of the major problems of all *qui tam* statutes has been

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119 Landes and Posner note:

> For example the Internal Revenue Service has repeatedly (but unsuccessfully) argued to its appropriations subcommittee that the Service is operating at a budgetary level where the marginal cost of enforcement is far below the marginal return, measured (as a private enforcer would measure it) by the additional tax revenue that additional expenditures on enforcement would generate. There is some evidence that this argument is correct.

Landes & Posner, *supra* note 3, at 36-37 (footnote omitted). Posner and Landes go on to explain the budgetary gap as originating from Congress' reasoned judgment that additional enforcement at the margin would result in too much enforcement. *Id.* at 37. The author takes issue with the propositions that congressional appropriations turn on such an analysis and that greater enforcement would be necessarily undesirable.

120 *Id.* at 36 & n.78; Comment, *Private Remedies Available Under Rule 10b-5,*

the popular distrust of informers.[121] In sixteenth century England, informers were referred to as "lewd" and the "worst kind of people."[122] During the Senate debates on the False Claims Act,[123] they were attacked as "racketeers."[124]

The costs of this negative image have been high. In England it became very difficult for even the most honest informer to bring successful prosecution. Professor Elton records the plight of one such well-meaning informer: "however dishonest Vincent [the alleged smuggler] may have been, no local jury was going to condemn the local man to please this informer from London."[125] Davies notes that even where a guilty verdict was returned, an attempt was usually made to reduce the informer's recovery.[126] The paucity of legitimate compensation made it necessary for many informers to engage in illegal settlements, which in turn further tarnished their image.[127] Finally, the antipathy for the informer was transferred to the very laws he sought to enforce which led to their repeal and promoted the concept of *laissez-faire*.[128]

2. False Claims

One of the reasons for the informer's negative image was the public's perception that a large percentage of the suits brought

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20 Sw. L.J. 620 (1966) ("lack of funds, manpower, and information necessitates additional pressures . . . to achieve full compliance"). *See also* note 43 *supra*.

121 Negative image is also a problem with the private compensatory action. Inadequate fee awards are often motivated by a judge's belief that attorneys are profiting at the expense of the class. *See* notes 66-68 and accompanying text *supra*. Such a judicial reaction may only tend to produce more unethical practices, for as the level of legitimate return is decreased, quality lawyers will begin to abandon class actions, leaving the field to the "sharks" of the practice. Interview with Samuel Seymour, noted class actions attorney and professor, in Charlottesville, Virginia, May 3, 1972. This will in turn lead to greater abuse and a further decrease in the legitimate return. The final result may well be the abolition of the class action. For a discussion of recent decisions that have restricted class actions *see* note 90 *supra*.

122 DAVIES, *supra* note 29, at 63.

123 See note 24 *supra*.

124 89 CONG. REC. 7439 (1943) (remarks of Senator Van Nuys).

125 Elton, *Informing for Profit*, 11 CAMBRIDGE HISTORICAL J. 149, 159 (1954).

126 DAVIES, *supra* note 29, at 57-58.

127 *Id.* at 156.

128 *Id.* at 157.

were spurious.[129] There is evidence that this belief was not totally unjustified. Davies notes that in sixteenth century England there were great incentives to bring bogus suits. Some defendants defaulted irrespective of the merits of the informer's suit, as this was often less expensive than protracted litigation.[130] Settlements were also common via a procedure known as a composition, whereby the defendant would admit to a smaller fine in return for release from further prosecution.[131]

False claims were also a major complaint with the False Claims Act. Senator Van Nuys cited the fact that actions were brought against such reputable individuals as former Vice-President Charles Dawes.[132] Many lawyers would bring suit on no other basis than a governmental investigation, hoping that they could later discover some evidence or "convince" the defendant to settle.[133]

3. Res Judicata

The opposite of the false claims problem is the collusive law suit which is brought in order to establish a bar to future bona fide actions. The preamble to a fifteenth century English statute[134] refers to this problem, citing the commonplace situation in which a friend of the wrongdoer would bring suit and either obtain a confessed judgment for a lesser part of the penalty or permit the wrongdoer to prevail at a feigned trial. There is also the problem of the honest but incompetent plaintiff who fails to present an adequate case. Should his loss bar a subsequent government prosecution?[135] This problem has been of relatively

129 For discussion of the false claims problem with the present private compensatory action, see text accompanying notes 80-88 *supra.*

130 DAVIES, *supra* note 29, at 58.

131 *Id.* at 51-54.

132 89 CONG. REC. 7437 (1943) (remarks of Senator Van Nuys).

133 *Id.* at 10,846.

134 4 Hen. 7, c. 20 (1488).

135 Section 3 of the Minnesota Environmental Rights Law, MINN. STAT. § 1168.03, subd. 5 (1974), provides that a prior citizen suit not bar any subsequent public suit. However, in Note, *Private Prosecution: A Remedy for District Attorneys' Unwarranted Inaction,* 65 YALE L.J. 209 (1955), it is asserted that "the defense of . . . res judicata would bar future state action," where the court substitutes a private prosecutor for a district attorney. *Id.* at 232.

little consequence[136] under the current scheme, since private and public enforcement are brought pursuant to two entirely different causes of action. However, it would resurface with the adoption of a *qui tam* action where the elements of the private case would be identical to the public prosecution and the private plaintiff is suing in the name of the government.

4. Prosecutorial Discretion

Prosecutorial discretion can be a form of administrative rule making which hones the rough edges of statutory law and makes allowances for unique situations. Where an action may also be brought by private persons, this function may be compromised.[137] Although at the zenith of the *qui tam* action there was little public prosecution with which to interfere, Sir Edward Coke did note that individuals were frequently harassed by informers who brought suit for violations of arcane and obsolete laws,[138] which presumably would not have been enforced by a public prosecutor.

B. *A Proposed Solution*

Most of the above problems were due to inadequate governmental control over the *qui tam* action. Prior to the twentieth century, with public prosecution in its embryonic stage, such control was probably impossible. Today, however, there is no reason why *qui tam* enforcement could not be closely regulated. A modified *qui tam* action should avoid most of the problems inherent in a scheme which relies on either the private compensatory action or total public enforcement and can be combined with a new compensation system.

The basic outline of such a modified *qui tam* action in the securities area is as follows: All persons would have the same right as the SEC to bring actions seeking the imposition of a

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136 *See* note 49 *supra*.

137 Areeda, *supra* note 52, at 8-9; Landes & Posner, *supra* note 3, at 38. The case of Abrams v. Occidental Petroleum Co., 450 F.2d 157 (2d Cir. 1971), where a 16(b) allegation (see note 15 *supra*) was used to facilitate a defensive merger, is an example of how literal enforcement in the context of a private compensatory action can be used to distort the very purpose of a statute.

138 3 E. Coke, Institutes, 191-92 (1797).

newly created civil penalty[139] for any violation of the securities laws. Such an action would be in the name of the United States and there could only be one such action for a particular alleged violation.[140] Prior to proceeding further with the suit the private enforcer would have to give the SEC notice of his filing and substantially all the evidence in his possession regarding the alleged violation.[141] The SEC would then have 60 days within which to: 1) preempt the private enforcer and bring suit itself; 2) ask the court to dismiss the private action; or 3) allow the private action to proceed.[142] In case 3), the prosecution of the suit would be totally within the private party's control, except that he could not withdraw or settle without the consent of the SEC and the court.[143]

The chief incentives for bringing such a suit would be the payment to the successful private enforcer of his litigation costs[144] plus an incentive award.[145] A private enforcer preempted by the government would be awarded a finder's fee based on the value of the information he gave the United States.[146] To prevent sloppily prosecuted or spurious suits a court would have the discretionary authority to require the plaintiff to pay the prevailing defendant his litigation expenses, for which it may also require the plaintiff to post bond.[147]

How the above proposal would meet each of the problems of the private compensatory action, public enforcement, and the historical *qui tam* action and how victims might be compensated after its adoption will be discussed below.

1. Perverse Incentives

The problem of a party who fails to mitigate the harm suffered would not exist in a modified *qui tam* action where the

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139 See § 9 of model statute *infra.*
140 See § 3 of model statute *infra.*
141 See § 5 of model statute *infra.*
142 See §§ 6-7 of model statute *infra.*
143 See § 10 of model statute *infra.*
144 See § 11 of model statute *infra.*
145 See § 12(b) of model statute *infra.*
146 See § 12(a) of model statute *infra.*
147 See § 11 of model statute *infra.*

harm suffered by the plaintiff would be unrelated to his potential recovery.

2. Prosecutorial Non-action[148]

Under the status quo the harm from the governmental tendency to decline bona fide cases is partially mitigated by the fact that a private party is still free to prosecute. The private enforcer's action is, however, an even better solution as there will be no standing barrier to the right of the enforcer to prosecute. Furthermore, the requirement of the proposed Act that the plaintiff give notice to the government of any suit he brings[149] will provide the public agency with an additional source of information about potential violations of the securities and antitrust laws and the opportunity to preempt and bring itself meritorious suits which it might not otherwise have discovered.[150] The government must also file a statement with the court within 60 days of notice of the private enforcer's action,[151] which may serve to flesh out and formalize the governmental decision-making process regarding whether prosecution should be brought. Finally, the possibility that a preempted enforcer coud challenge the government for a lack of diligence[152] should provide a significant check on government laxity which is not now available.

3. False Claims

The problem of false claims would be dealt with in several ways. First, both the SEC and the court would be given extensive power over the *qui tam* action. The government would be given the right to comment on the merits of the proposed *qui tam* action and, if the situation warranted, ask the court to terminate the suit.[153]

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148 How the *qui tam* statute would not interfere with the positive side of governmental non-action, prosecutorial discretion, will be dealt with in text accompanying notes 170-173 *infra*.
149 See § 5 of model statute *infra*.
150 See § 6 of model statute *infra*.
151 See § 7 of model statute *infra*.
152 See proviso to § 6 of model statute *infra*.
153 See § 7 of model statute *infra*.

Second, all settlements would require the approval of both the SEC and the court.[154] Secret settlements might still exist, but since there would be no res judicata effect, the defendant would still be exposed to the risk of future prosecution. As priority among competing informers would be based solely on the date of filing,[155] a plaintiff who engaged in covert negotiations would run the substantial risk of losing his cause of action, especially in the case of massive violations which will attract the interest of a large number of private enforcers.

Furthermore, since the private compensatory action, with its array of collateral issues,[156] will be replaced with a *qui tam* action[157] identical to a public action, the defendant should better be able to recognize a spurious case.

Finally, there would be substantial disincentives to bringing false claims. The fact that each complaint must be processed through the public enforcement agency should encourage a process of self-selection. Few attorneys who intend to file future actions would intentionally bring a frivolous claim. The court would also be given the power to assess costs (including attorneys' fees) against the unsuccessful plaintiff.[158]

4. Strain on the Judiciary

The court's task will be greatly simplified by the substitution of the *qui tam* action for private compensatory suit. All enforcement suits to impose the civil penalty, both public and private, would involve substantially the same issues. Although *qui tam* actions would require some judicial supervision[159] it would cer-

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154 See § 10 of model statute *infra.*

155 See § 8 of model statute *infra.*

156 "Collateral issues" means, not whether the defendant has violated the law, but rather whether he directly or indirectly harmed the particular plaintiff. See notes 50-54 *supra.*

157 See § 3 of model statute *infra.*

158 See § 11 of model statute *infra.* While it is envisioned that courts would always award costs to the prevailing plaintiff, it is intended that the defendant's costs be charged to the plaintiff only where it develops that the enforcer's suit was substantially without merit.

159 The chief areas would be determination of the amount of civil penalties, ratification of settlements, the assessments of cost, and the awarding of the finder's fee and the enforcer's award. See §§ 9-12 of model statute *infra.*

tainly be less than is currently required by the class action,[160] and there would only be one suit per violation.[161]

5. Non-optimal Enforcement

Because there would only be one *qui tam* suit per violation rather than many private actions as now often exist with the private compensatory action,[162] the court which decided a violation had occurred would have far more control over the sanction imposed. Even more significantly, the level of enforcement could be "finely tuned" by the courts and the SEC.[163] Simply adjusting the returns that an informer could obtain would increase or decrease the level of enforcement and, similarly, changing the amount of the fine would alter the deterrent impact on potential defendants.[164] The ability of the IRS to expand or contract the level of capital investment by adjusting the rates of depreciation[165] offers precedent for such fine tuning.[166]

6. Res Judicata

The fact that, under the statute, a *qui tam* action would bar any future government[167] suit (and vice versa)[168] should present no problem, as the government has ample right to either preempt

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160 See text accompanying notes 89-90 *supra*.

161 See § 3 of model statute *infra*.

162 The government's action against Texas Gulf Sulphur resulted in dozens of private suits. Cannon v. Texas Gulf Sulphur Co., 55 F.R.D. 308, 311 (S.D.N.Y. 1972). Although the class action is designed to consolidate multiple private actions, a damage suit is often not susceptible to class treatment. Cannon v. Texas Gulf Sulphur Co., 55 F.R.D. 306, 307 (S.D.N.Y. 1971). *But see* Elkind v. Liggett & Myers, Inc., 66 F.R.D. 36, 40 (S.D.N.Y. 1975).

163 See § 12 of the model statute *infra*.

164 See § 9 of model statute *infra*.

165 INT. REV. CODE OF 1954, § 167(m). The IRS may adopt "a class life depreciation system . . . . [T]he Treasury Department is given authority to prescribe class lives based on anticipated industry norms (or norms based on other classes) . . . . [T]he Internal Revenue Service may permit depreciation lives within a range of 20 percent above or below class life." J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION: CODE COMMENTARY 363 (1973).

166 For an explanation of the ability of depreciation rates to affect capital investment see R. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 336-46 (1959). *But see*, Eisner, *Effects of Depreciation Allowances for Tax Purposes*, in 2 TAX REVISION COMPENDIUM 793, 795-96 (1959).

167 See § 3 of model statute *infra*.

168 See § 6 of model statute *infra*.

or terminate any suit where it is feared that the informer would lose. The government would also have the power to alter the priority among informers by requesting dismissal and thus allowing another informer to prosecute the action.[169]

7. Prosecutorial Discretion

One of the problems with the private compensatory action is that the government has very little control over it. At present, if a private action is filed which the government disapproves, its only recourse is the filing of an amicus brief. Under the model statute the government would have the right to preempt or request the termination of the private suit[170] as well as the power of comment.[171] Finally, it is presently difficult to insure that the government will be able to exercise what little influence it does have, as there is no formal means by which the government is advised of private actions.[172] The requirement of notice in the proposed statute[173] solves this problem.

8. Negative Image

The close integration between the private enforcer and the government will hopefully obviate much of the negative image problem. If the problem remains, a licensing procedure whereby *qui tam* actions could be brought only by "approved" attorneys could always be instituted. Note that, under the model statute, the SEC could use its termination power to prevent unworthy lawyers from suing.[174]

C. *Alternative Compensation Systems*

If private compensatory actions under the securities and antitrust statutes are to be replaced by a general private enforcer's

169 See § 8 of model statute *infra.*

170 Because the court would have to consent to any termination of a private suit, the government could not arbitrarily create an exemption by refusing to allow the informer to prosecute. See text accompanying notes 148-52 *supra* for a discussion of how *qui tam* would compensate for prosecutorial non-action.

171 See § 7 of model statute *infra.*

172 See note 69 *supra.*

173 See § 5 of model statute *infra.*

174 See § 7(a)(4) of model statute *infra.*

action, in which standing does not depend on injury, how will victims be compensated? First, the fact that common law tort actions for fraud, deceit, and unfair competition will continue to exist should not be overlooked. Even if all express or implied federal statutory private actions are abolished, the victim may nevertheless sue in a state court and obtain compensation. However, he will have to prove all the essential elements of fraud or deceit under state tort law such as privity, falsity, *scienter*, reasonable reliance, injury, and proximate cause. In addition, victims may have remedies available to them under state blue sky and antitrust laws.

One might predict that, in the absence of any other remedial relief for victims of fraudulent securities issuers and brokers and illegal monopolists, state courts might lower the obstacles to recovery in such suits just as they have in the statutory actions. Relying on common and state law remedies presents a dilemma. Insisting on proof of all the conventional elements of liability would deny much relief which is now available, but facilitating recovery by lowering such barriers would result in the same poorly regulated and inefficient deterrence which characterizes the existing system.

A perhaps more desirable solution would be to look to the money obtained through the civil penalty[175] (after subtracting the enforcer's litigation costs[176] and award[177]) as a restitutionary fund to which victims of the violation could apply for the damages they have suffered. To prevent such a compensation scheme from unduly burdening the judiciary it could be administered by a new quasi-judicial agency (perhaps funded out of the civil penalties) in the same manner as the Social Security or Workmen's Compenastion systems. The SEC in the *Texas Gulf Sulphur* case used its injunctive powers to create such a restitutionary fund for victims.[178]

Proposals for similar approaches to compensation in the securities and antitrust areas have included recoveries from attached

175 See § 9 of model statute *infra*.

176 See § 11(a) of model statute *infra*.

177 See § 12(b) of model statute *infra*.

178 SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971). *See* note 9 *supra*.

illegal profits,[179] *parens patriae* suits,[180] and procedures to consolidate all victim actions in one court combined with overall limits on damages.[181] It may also be helpful to look to examples of and proposals for systems to compensate victims of violent crime.[182] Of course, it cannot be pretended that these alternatives will eliminate the problems of determining whether the applicant has been injured by the violation and measuring his damages, but the issue would arguably be more manageable at the administrative level where expensive full-scale litigation can be avoided and regulations can be promulgated and refined with experience. Moreover, the criteria for recovery can be developed without distorting efforts at deterrence, which can be pursued independently by the SEC or Antitrust Division and the courts.

An issue the compensation agency would surely confront is what to do when the damages appear to exceed what is in the civil penalty fund.[183] Arguably an amount which may be as high as triple the offender's illegal profits would usually be sufficient even after subtracting for litigation costs and the en-

179 *Corporate Crime, supra* note 9, at 298-301 (Victims could sue until government action was brought, after which all victim suits would be stayed. If the government won, victims could usually sue the government for recovery from the fund created by the attached illegal profits.)

180 This could be a variation of the recovery of illegal profits under § 9(b) of the model statute *infra. See* Hawaii v. Standard Oil Co., 405 U.S. 251, 257-60 (1972); Dam, *supra* note 11, at 64-66; Malina & Blechman, *Parens Patriae Suits for Treble Damages Under the Antitrust Laws*, 65 Nw. U.L. Rev. 193 (1970); Note, *State Protection of its Economy and Environment: Parens Patriae Suits for Damages*, 6 Col. J.L. Soc. Prob. 411 (1970); Comment, *Wrongs Without Remedy: The Concept of Parens Patriae Suits for Treble Damages Under the Antitrust Laws*, 43 S. Cal. L. Rev. 570, 584-93 (1970).

For unenacted congressional proposals which would allow distribution to individual victims after a *parens patriae* suit see H.R. 38, 94th Cong., 1st Sess. (1975); H.R. 2850, 94th Cong., 1st Sess. (1975).

181 Federal Securities Code § 1409 & Comment (Tent. Draft No. 2, 1973).

182 For unenacted congressional proposals to establish a compensation system for victims of violent crime, see S. 2022, 94th Cong., 1st Sess. (1975); H.R. 8753, 94th Cong., 1st Sess. (1975); H.R. 9074, 94th Cong., 1st Sess. (1975). A 1973 Senate floor amendment, which would have created such a compensation system, passed the Senate. 119 Cong. Rec. S 18,693-96 (daily ed. Oct. 8, 1973) (includes text of amendment). However, the Senate receded after the amendment was rejected by the House. *See generally Symposium: Governmental Compensation for Victims of Violence*, 43 S. Cal. L. Rev. 1-254 (1970) (entire issue).

183 One approach is to allow all the victims to sue, require the defendant to pay any excess damages, but permit him to individually defend against the claims. *Corporate Crime, supra* note 9, at 300-01. Another solution is to prorate among claimants. Federal Securities Code § 1409 (Tent. Draft No. 2, 1973).

forcer's award. If money were left in the fund after some "statute of limitations" had expired, it could be retained and used to fund additional enforcement efforts by the SEC or the Antitrust Division.

It is at least theoretically conceivable that a substantial violation might occur, for which neither the government nor a *qui tam* enforcer brings suit. Since the victim presumably has more information about the apparent violation than anyone else, it would be logical to expect him to bring an enforcer's suit himself (or hire a lawyer to do so), in which case he could recover an enforcer's award in addition to his damages and be in control of the prosecution of the suit as well.

Surely, such an alternative compensatory solution in the antitrust and securities context and the problems associated with it need further debate and resolution. While such a discussion is considered to be beyond the scope of this article, it is submitted that the lack of a full-blown compensation proposal should not delay discussion of and experimentation with the modified *qui tam* action in securities and antitrust enforcement.

Conclusion

The goal of every enforcement system (as distinguished from a compensation system) is to produce the optimal level of deterrence for the least cost. The present system of antitrust and securities enforcement, with its heavy reliance on the private compensatory and class actions does not appear to achieve this end. It has been contended that not only do private actions fail to produce appropriate deterrence; their use also often doesn't adequately compensate victims and creates additional problems. Even the most ardent supporters of private compensatory (victim) enforcement admit these flaws are serious but rejoin that the commonly suggested alternative, total public enforcement, is simply not feasible, given the problem of inadequate funding and objectionable prosecutorial incentives, and ignores compensation altogether.

The answer to the defects in both victim and public enforcement may be a modified form of the ancient *qui tam* action, which is proposed in the following model statute. It would allow any citizen, regardless of whether he was personally adversely affected by a violation, to bring suit and be rewarded if successful with a portion of the fine. This approach is an alternative to public enforcement without many of the costs normally associated with compensatory actions and can be integrated with new modes of compensation. Although the *qui tam* action has been plagued by significant problems in the past, these can be avoided or mitigated by giving the public prosecutor the power to control the initiation and termination of such actions. The *qui tam* action, as outlined in the model statute, deserves to be seriously considered as a complement to public enforcement and as a possible eventual replacement for victim enforcement.

A FEDERAL PRIVATE ENFORCER'S ACT

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COMMENT: Although the following statutory proposal is designed only for enforcement of federal securities law, it easily could be adopted for use with the antitrust laws and conceivably other regulatory statutes.

The word "enforcer" rather than informer is used because the latter term has a negative connotation and because it is not totally accurate. Under this Act it is unnecessary for the private party to discover any new information in order to prosecute a violation of the federal securities laws. Although Section 12(a) *infra* grants a private party a finder's fee for helpful information, the generation of information is only a secondary aim of the Act. Its primary purpose is to complement public enforcement with more effective private enforcement.

Section 1. *Definitions*

For purposes of this Act —

(a) "Enforcer" means any person who, as a private citizen, files an action authorized by Section 3 of this Act on behalf of and in the name of the Commission in order to enforce the provisions of the securities laws of the United States.

(b) "Securities laws of the United States" means the Securities Act of 1933 and the Securities Exchange Act of 1934 and all amendments thereto.

(c) "Commission" means the Securities and Exchange Commission.

Section 2. *Repeal of Private Actions* [Optional]

All express or implied authorization for private actions for monetary relief under the Securities Act of 1933 and the Securities Exchange Act of 1934 is abolished, provided that this section shall not affect any such action which has been filed as of the effective date of this Act.

COMMENT: It is not essential that the private compensatory action be immediately abolished. This section is therefore optional. It may be expedient to simply temporarily add the private enforcer's action to the present arsenal of enforcement; Congress may desire to test the effectiveness of such actions before abolishing the private compensatory action. It may be advisable to gradually phase out this group of private compensatory actions to prevent the amount of enforcement from dropping during the transition period and to allow time for consideration and development of alternative compensation systems.[184]

This section would not repeal an aggrieved party's (victim's) right to bring action for injunctive relief but abolishes all actions for monetary relief including rescission, which is essentially a

184 See notes 175-83 and accompanying text *supra*.

measure of damages in an otherwise ordinary compensatory action.

This section repeals implied causes of action (such as 10b-5 suits) as well as those which are creatures of express statutory language.

Section 3. *Authorization for Actions to Impose Civil Penalties by Enforcers or the Commission*

Any person who violates any of the provisions of the securities laws of the United States or the rules and regulations promulgated by the Commission under the authority of such laws shall be liable for a civil penalty in an amount determined as specified in Section 9 of this Act. Any person may bring a civil action at law to impose such penalty in the name of the Commission in any United States district court of competent jurisdiction at his own expense and shall be awarded a portion of any such penalty imposed, determined as specified in Sections 11 and 12 of this Act. The Commission may also bring an action under this Section. Except as provided in Subsection 7(a)(4) of this Act, only one action for each alleged violation may be brought under this section.

COMMENT: This Section creates a new cause of action for both private enforcers and the SEC. The SEC would continue to have the authority to refer what it believes to be willful violations to the Justice Department for criminal prosecution[185] and to use its injunctive powers[186] to prevent or stop violations from occurring. Under this section, the action is a civil proceeding to impose a civil penalty for any violation, even if not willful.[187] It is expected that the judicial standards now governing whether the defendant's conduct complies with the securities laws in private com-

185 See note 6 *supra*.

186 See note 7 *supra*.

187 Examples of existing civil monetary penalties for violations of federal statutes include Consumer Product Safety Act § 20, 15 U.S.C. § 2069 (Supp. III, 1973); Federal Water Pollution Control Act § 309(d), 33 U.S.C. § 1319(d) (Supp. III, 1973); Clean Air Act § 205, 42 U.S.C. § 1857f-4 (1970). Where a civil penalty provision of a federal statute does not specify the mode of recovery, the penalty may be recovered in a civil action. Judicial Code, 28 U.S.C. § 2461(a) (1970). The Supreme Court has held that the double damages plus $2000 penalty under the False Claims Act § 3, 31 U.S.C. § 231, is a civil sanction recoverable by an informer in a civil proceeding under 31 U.S.C. § 232. United States v. Hess, 317 U.S. 537, 549 (1943).

pensatory and injunction cases will be applied. Either the private enforcer or the SEC may initiate the action but only one action can be prosecuted to settlement or judgment for each violation.

The most salient advantages of this action are that judicial standards of liability will be the same in both public and private suits and, by definition, the conduct, relationship to the defendant, and state of mind of the plaintiff will be irrelevant in the enforcer's action. The private enforcer truly will be a special public prosecutor or private attorney general. It has been held under the citizen enforcement provision of the Clean Air Act[188] that Congress has the power to confer standing on a plaintiff suing for enforcement of a federal statute without requiring the plaintiff to make a showing of injury from the defendant's conduct.[189]

Section 4. *Jurisdiction*

The United States district courts shall have exclusive jurisdiction of all actions brought under Section 3 of this Act. Any such action may be brought in the district wherein any act or transaction constituting the violation occurred, or wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in Sections 1254, 1291, 1292, and 1294 of Title 28, United States Code.

COMMENT: This section is adapted from the jurisdictional provision of the Securities Exchange Act of 1934.[190]

Section 5. *Notice of the Enforcer's Action*

Whenever any enforcer's suit is brought under Section 3 of this Act, notice of the pendency of such suit shall be given to the Commission by sending to the Commission a copy of the complaint together with a disclosure in writing of substantially all evidence and

188 § 304(a), 42 U.S.C. § 1857h-2(a) (1970).

189 Metro. Washington Coalition for Clean Air v. District of Columbia, 511 F.2d 809, 814 (D.C. Cir. 1975); *see* Sierra Club v. Morton, 405 U.S. 727, 732 n.3 (1972).

190 § 27, 15 U.S.C. § 78aa (1970).

information in the enforcer's possession material to the effective prosecution of such suit, according to regulations promulgated by the Commission. The court shall not allow further prosecution of the suit by the enforcer until more than sixty days after such notice has been sent to the Commission.

COMMENT: This notice provision is an obvious prerequisite to the control of the enforcer's suit by the SEC. A similar provision is found in the False Claims Act[191] as well as in the citizen enforcement provisions of the Federal Water Pollution Control Act,[192] the Noise Control Act of 1972,[193] the Clean Air Act,[194] and the Consumer Product Safety Act.[195] Here, unlike the last three acts, jurisdiction is not dependent upon the fulfillment of the notice requirement. The suit, however, cannot proceed further until the notice requirement has been met.

Section 6. *Preemption of the Enforcer's Action by the Commission*

(a) The Commission shall have sixty days, after notice as provided in Section 5 of this Act, within which to enter appearance in a suit brought by an enforcer. If the Commission within said period enters an appearance in such suit, the suit shall be carried on solely by the Commission. In carrying on such suit the Commission shall not be bound by any action taken by the enforcer who brought it, and may proceed in all respects as if it were instituting the suit. Provided, that if the Commission shall fail to carry on such suit with due diligence within a period of six months from the date of its appearance therein or within such additional time as the court after notice may allow, the court may upon motion allow such suit to thereafter be prosecuted by the enforcer who originally brought it or, if that person no longer desires to prosecute the suit, any other enforcer who files pursuant to Section 3.

(b) If the Commission prosecutes such suit to final settlement or judgment, no person may thereafter bring an action under Section 3 of this Act for the same alleged violation.

COMMENT: The right of preemption is essential if the SEC is

191 31 U.S.C. § 232(C) (1970).
192 § 505(b), 33 U.S.C. § 1365(b) (Supp. III, 1973).
193 § 12(b), 42 U.S.C. § 4911(b) (Supp. III, 1973).
194 § 304(b), 42 U.S.C. § 1857h-2(b) (1970).
195 § 24, 15 U.S.C. § 2073 (Supp. III, 1973).

to take advantage of the discovery by enforcers of opportunities to argue in an appropriate case for a new precedent consistent with SEC enforcement philosophy and to be protected against suits brought by enforcers whom it believes to be incompetent. Since only one suit per violation is allowed, the defendant would be insulated from government prosecution for a civil penalty once an enforcer lost his suit. As the primary purpose of this statute is to aid public enforcement, the right of the government to preempt is totally discretionary. A preempted enforcer's interests are protected to the extent that he may be entitled to a finder's fee under Section 12(a) and may be reawarded prosecution of the suit. The proviso is added to prevent the government from arbitrarily preempting a suit when it has little intention of prosecuting it. If the suit lacks merit, the government should move for termination pursuant to Subsection 7(a)(4). The proviso also creates a general check on prosecutorial laxity which is lacking under the present system. Both the right of preemption and the right of the private party to be re-substituted for the government, if the government has not been diligent, are found in the False Claims Act.[196] Under the Federal Water Pollution Control Act,[197] the Noise Control Act of 1972,[198] and the Clean Air Act[199] citizen actions may not be commenced if the government is diligently prosecuting an action for compliance within 60 days of notice alleging a statutory violation.

Section 7. *Comment on and Termination of the Enforcer's Action by the Commission*

(a) If the Commission chooses not to enter an appearance it shall, within 60 days of notice of the enforcer's suit, file a statement with the court that:

(1) the Commission finds that the enforcer has a meritorious prima facie case but that the Commission is without present ability to prosecute the case; or

196 31 U.S.C. § 232(C) (1970). The diligence issue has arisen in at least one case, United States v. Baker-Lockwood Mfg. Co., 138 F.2d 48, 52-53 (8th Cir. 1943), *rev'd per curiam on other grounds sub nom.* Nathanson v. United States, 321 U.S. 746 (1944).

197 § 505(b)(1)(B), 33 U.S.C. § 1365(b)(1)(B) (Supp. III, 1973).

198 § 12(b)(1)(B), 42 U.S.C. § 4911(b)(1)(B), (Supp. III, 1973).

199 § 304(b)(1)(B), 42 U.S.C. § 1857h-2(b)(1)(B) (1970).

(2) the Commission chooses not to comment on the enforcer's complaint; or

(3) the Commission views the enforcer's complaint unfavorably; or

(4) the Commission views the enforcer's complaint unfavorably and requests the court to dismiss it, provided that such dismissal shall not affect the rights of the Commission or another enforcer from bringing subsequent action for the same alleged violation.

(b) The failure to file a statement commenting on the enforcer's complaint as required under this section shall not prevent the enforcer from prosecuting his suit but shall be considered equivalent to Subsection (a)(2) of this section.

(c) Whenever the Commission chooses to file statements as provided in Subsections (a)(1), (a)(3), and (a)(4) of this section, it may include reasons supporting its conclusion. Any statement filed under Subsection (a) of this section shall be admissible as evidence in the enforcer's suit.

(d) If the enforcer's suit is neither preempted nor dismissed, prosecution of the suit, except as otherwise provided in Section 10 of this Act, shall be controlled by the enforcer.

COMMENT: This section is designed to give the SEC maximum flexibility in controlling enforcers' suits. Comment under Subsections (a)(1) or (a)(3) of this section is essentially analogous to the government's present right to participate in a private action by filing amicus briefs. Such comment is admissible into evidence in the enforcer's suit. Although comment is a mandatory requirement, it is realized that the government may often ignore the filing of the enforcer's suit; hence Subsection (b) allows the enforcer to proceed as if the SEC had filed a "no comment" statement.

The SEC's power to request that the enforcer's action be dismissed is based in part on the prosecutor's common law right of *nolle prosequi,* which allows him to declare formally that he will prosecute a case no further. As in the *Federal Rules of Criminal Procedure*[200] termination here requires the consent of the court. This requirement of consent provides an opportunity for the court to review the exercise of prosecutorial discretion. The

200 FED. R. CRIM. P. 48.

proviso incorporates the general law of *nolle prosequi* which holds that termination does not bar a second prosecution.[201]

It is anticipated that the SEC would request termination in four situations: 1) where there was insufficient evidence that the violation occurred, *i.e.*, the probability of liability was so low that the suit appeared to be a false or frivolous claim; 2) where the government believed that the enforcer might incompetently prosecute the suit (even though it may have merit), but it did not want to bring the suit at the present time (thus ruling out preemption); 3) where the government felt that another later-filing enforcer might be better qualified to bring the prosecution; 4) as part of the exercise of prosecutorial discretion, *i.e.*, in instances where the government felt that in the particular situation the purposes of the securities laws would not be served by prosecution or that such prosecution would disrupt informal governmental attempts at compliance.

If the SEC did not take action to either preempt or terminate the enforcer's suit within the 60 day period, control of the suit would pass totally to the enforcer under Subsection (d). Of course the SEC could still file an amicus brief, its consent would be necessary for any settlement under Section 10 (though it could not enter into its own settlement with the defendant), and it could make recommendations regarding the enforcer's award under Section 12.

Section 8. *Priority Among Enforcers*

Priority among enforcers shall be determined by order of filing. Unless the prior enforcer's action has been dismissed pursuant to Section 7 of this Act, or withdrawn without prejudice pursuant to Section 10 of this Act, no subsequent enforcer shall have any right to bring an enforcer's action under Section 3 of this Act.

COMMENT: Section 3 of the statute allows only one enforcer's action against a given defendant for a particular violation of the securities law unless an action is terminated under Section 7[202]

201 Dortch v. United States, 203 F.2d 709, 710 (6th Cir.), *cert. denied*, 346 U.S. 814 (1953); United States v. Fox, 130 F.2d 56 (3d Cir.), *cert. denied*, 317 U.S. 666 (1942).

202 Under the False Claims Act, it has been held that only one informer may

or withdrawn without prejudice under Section 10. Related but different causes of action could be consolidated as with any other suit. The major check on the filing of "barebones" complaints solely to achieve priority is the SEC's power to terminate under Subsection 7(a)(4).

Section 9. *Civil Penalties*

Any person found to have violated the securities laws of the United States in a suit authorized by Section 3 of this Act shall pay, as a civil penalty, to the United States:

(a) a maximum of $100,000 if an individual or $1,000,000 if a corporation, the amount to be determined by the court, after considering any recommendation made by the Commission; or

(b) upon proof by the enforcer or the Commission that the offender acquired profits resulting from such violation which would not have been acquired in the absence of such violation, an amount not less than such profits but not greater than triple such profits, at the discretion of the court, after considering any recommendation made by the Commission.

COMMENT: As discussed above, criminal fines under both the securities and antitrust laws have been criticized as inadequate deterrents.[203] This section attempts to remedy the problem both by increasing the level of the maximum statutory fine (also imposing it after a civil rather than criminal proceeding[204] and not coupling it with imprisonment) and alternatively allowing the prosecutor to prove that the actual level of unlawfully obtained profits is even higher, in which case the defendant may be liable for disgorging up to triple the amount of the illegal profits.

The statutory maximum penalty in Subsection (a) is set at the same levels as in the recent amendments to the criminal penalty provisions of the antitrust laws.[205] It is anticipated that the judge and the SEC will consider the magnitude of the violation as evidenced by illegal profits, rough measures of damage inflicted upon

sue for a single illegality. United States v. B.F. Goodrich Co., 41 F. Supp. 574 (S.D.N.Y. 1941).

203 *See* note 11 *supra.*

204 See note 187 *supra.*

204 See note 187 *supra.*

205 *See* note 11 *supra.*

victims, and the degree of willfulness. Under Subsection (a) the court must assess a penalty even though the amount of illegal profits has not been litigated.

In cases of massive violation, the prosecutor may be able to prove under Subsection (b) that the amount of illegal profits exceeded the maximums specified in Subsection (a). The defendant may be able to show that part or all the profits would have been earned even in the absence of any illegality and thus have the penalty reduced.[206] Without this provision, if the illegal profits exceeded the penalty, there would obviously be an incentive for the defendant to pay the fine and continue breaking the law. Those potential offenders whom the penalty is supposed to deter would also be tempted to break the law and take the risk. Allowing the penalty to be increased to as high as triple the profits is necessary in order to compensate for the probability that the violator will not be apprehended and found liable, *i.e.*, a calculating corporate criminal may be willing to risk a $150,000 penalty in order to make $100,000 in profits if the probability of the penalty being imposed is only 0.5 (this of course depends among other things on how risk averse he is).[207] The SEC, which is perhaps in the best position to estimate such probabilities, will be allowed to recommend the level of the penalty under Subsection (b).

While litigating the amount of illegal profits will involve some judicial time and cost, it is necessary in order to refine the deterrence impact of securities law enforcement and certainly is not so burdensome as dealing with all the problems discussed above concerning the conduct of the plaintiff in compensatory actions.[208]

Section 10. *Settlement*

Any suit brought by an enforcer shall not be withdrawn or dis-

206 Requiring corporate defendants to pay illegal profits into a restitutionary fund has been suggested. *Corporate Crime, supra* note 9, at 298-300. Using such an approach under existing SEC injunctive powers was judicially approved in one of the *Texas Gulf Sulphur* opinions. SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

207 Becker and Stigler, apparently assuming risk neutrality (*i.e.*, the defendant will risk losses in the short run if the probabilities indicate a net gain in the long run) suggest that the optimal fine is equal to damages divided by the probability of conviction. Becker & Stigler, *supra* note 3, at 15.

208 *See* notes 50-54 and accompanying text *supra*.

continued without the written consent of the court and the Commission, both of which shall set forth their reasons for such consent. The court shall consider any recommendation made by the Commission in determining whether the dismissal is with or without prejudice to the right of subsequent action pursuant to Section 3 for the same alleged violation.

COMMENT: This restriction on the enforcer's ability to settle is modeled after a similar provision in the False Claims Act.[209] It should serve as another deterrent to frivolous claims. Enforcers will know that they cannot use nuisance suits to obtain a quick settlement. The court and the SEC should consent only when the defendant is willing to pay an amount which will deter potential offenders.

Section 11. *Litigation Costs; Bond*

(a) If the defendant in a suit brought by an enforcer is found liable, the enforcer shall be awarded, out of the civil penalty resulting from such suit, his costs of litigation, including reasonable and necessary attorney and expert fees as determined by the court. The amount awarded under this section may not exceed the amount of the civil penalty imposed by Section 9 of this Act.

(b) The court may, when it deems appropriate, require the enforcer to pay the prevailing defendant's costs of litigation, including reasonable and necessary attorney and expert fees as determined by the court. The court may also require the enforcer to post a bond sufficient to cover any or all of the defendant's litigation costs.

(c) The Commission shall promulgate regulations specifying criteria to be considered by the court in assessing litigation costs under this section.

COMMENT: Allowing the award of litigation costs to the prevailing plaintiff is common in citizen enforcement statutes[210] and is also found in the statutory language of the antitrust treble

209 § 4, 31 U.S.C. § 232(B) (1970).

210 *See, e.g.*, Consumer Product Safety Act § 24, 15 U.S.C. § 2073 (Supp. III, 1973) (if plaintiff so elects, costs are always awarded to the prevailing party); False Claims Act § 6, 31 U.S.C. § 232(E)(2) (1970); Federal Water Pollution Control Act § 505(d), 33 U.S.C. § 1365(d) (Supp. III, 1973); Clean Air Act § 304(d), 42 U.S.C. § 1857h-2(d) (1970); Noise Control Act of 1972 § 12(d), 42 U.S.C. § 4911(d) (Supp. III, 1973).

damages provision.[211] The court may not award litigation costs in excess of the civil penalty imposed on the defendant. This is meant to discourage private enforcer's suits where the costs of prosecution are greater than the amount calculated to be necessary to deter the unlawful conduct. Such overenforcement would result in a net economic loss.

Under this section, while a court must award litigation expenses to the prevailing plaintiff, the award of costs to the prevailing defendant is totally discretionary. It is felt that an automatic assessment against an unsuccessful enforcer would be an unnecessarily severe disincentive. The possibility of an award was included, however, in order to create a disincentive to ill-conceived or malicious suits which get through the SEC "screen." In any situation where it appears doubtful to the court that the enforcer will prevail, the court has the right to order a bond. This requirement is similar to the laws regulating shareholder derivative actions,[212] which are also designed to deter nuisance suits.

Section 12. *Enforcer's Award*

(a) In any suit brought by an enforcer, if preempted by the Commission as provided in Section 6 of this Act, the court may award to the enforcer, out of the civil penalty resulting from such suit, an amount which in the judgment of the court is fair and reasonable compensation to the enforcer for disclosure of the information or evidence not in the possession of the United States when such suit was brought. The court shall take into consideration the cost of obtaining such evidence and written recommendation as to an appropriate amount, which shall be submitted by the Commission.

(b) In any such suit, if not preempted by the Commission, the court may, after considering any recommendation made by the Commission, award to the enforcer who brought such suit and prosecuted it to final judgment, out of the civil penalty resulting from such suit,

211 Clayton Antitrust Act § 4, 15 U.S.C. § 15 (1970). A plaintiff is entitled to attorneys' fees under this provision as long as he establishes a right to recovery, notwithstanding the fact that his proof of damages is too conjectural to support a damage award, Finley v. Music Corp. of America, 66 F. Supp. 569, 571 (S.D. Cal. 1946).

212 *E.g.*, CAL. CORP. § 834(b) (West Supp. 1975); N.Y. BUS. CORP. CODE § 627 (McKinney 1963).

an amount not greater than the amount by which the civil penalty exceeds the litigation costs awarded the enforcer under Section 11 of this Act, which in the judgment of the court is fair and reasonable compensation.

(c) The Commission shall promulgate regulations specifying factors to be considered by the courts in making awards to enforcers under this section.

COMMENT: Subsection (a), which is based in part on a similar section of the False Claims Act,[213] is included in order to compensate a preempted enforcer for any valuable information which he provided the government. The False Claims Act limits the award for information to ten percent of the total award. It is felt that such a statutory limit is too arbitrary. In order to provide some flexibility the SEC is required to submit its written recommendations based on an assessment of the cost of obtaining and value of the evidence in the particular case. Under Subsection (a) the enforcer receives nothing until and unless the government wins. It may be desirable to allow the government to pay the person who furnishes the information at the commencement of the action and to allow for a bonus if the government's prosecution is successful. Such rewards could be taken from general sources or from a special fund derived from civil penalties paid by violators under this Act.

The determination of the enforcer's award under Subsection (b) is a crucial component of the ability of the courts and the SEC to adjust the level of private enforcement of the securities laws. The only limit on the amount of the award is that litigation costs plus the award not exceed the penalty, which is designed to discourage actions where enforcement costs are greater than any benefit which might accrue. The SEC is required to make rules listing factors to be considered in making awards within this range, which would include the amount of the enforcer's litigation costs, and might also include the risk borne by the enforcer, the importance and complexity of the suit, and the need to encourage or discourage particular categories of prosecution. The SEC may also submit recommendations in individual cases. It

213 31 U.S.C. § 232(E)(1) (1970).

should be kept in mind that the SEC can also reduce the level of enforcement by asking for terminations under Subsection 7(a)(4).

Section 13. *Regulations*

The Commission shall have the authority to promulgate such regulations as may be necessary to efficiently and effectively carry out the purposes of this Act.

STATUTE

A PROPOSAL FOR A REVISED PRICE DISCRIMINATION AND PREDATORY PRICING STATUTE

CHRISTIAN L. CAMPBELL*
and
STEVEN L. EMANUEL**

Commentators and politicians have suggested the need for revising or eliminating the Robinson-Patman Act, which prohibits price discrimination. The United States Justice Department has recently made a specific statutory proposal for revising the Act; that proposal also contains a ban on certain "predatory" pricing practices not barred under any existing law. Messrs. Campbell and Emanuel, after examining the economic implications of the present Act, propose a revision of the Act differing in several important respects from the Justice Department proposal. Perhaps the most important of these relates to the circumstances under which a defendant charged with price discrimination may defend on the grounds that he was attempting in good faith to meet the lower price of a competitor. The Campbell and Emanuel proposal would allow this defense in fewer situations than either the existing Act or the Justice Department proposal.

The Campbell and Emanuel proposal would, like that of the Justice Department, prohibit certain non-discriminatory pricing practices that are "predatory" The proposal builds on a concept of "average direct operating expenses" to approximate the economists' notion of "marginal cost". The legality of certain pricing practices under the proposal is judged by reference to whether the prices charged are above or below these "average direct operating expenses."

Introduction

The Robinson-Patman Act (RPA) was enacted by Congress in 1936, largely in response to the rise of chain stores in the post-World War 1 era.[1] The large chains could operate more efficiently than their smaller rivals due to significant economies of scale in the mass production and distribution of goods. Further, their large size afforded them considerable bargaining power to exact special price concessions from their suppliers not uniformly granted to all purchasers.

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1 *See, e.g.*, F.T.C., CHAIN STORES, S. Doc. No. 4, 74th Cong., 1st Sess. (1935); *Hearings Before House Special Comm. to Investigate American Retail Federation*, 74th Cong., 1st Sess. (1935); H.R. Rep. No. 2287, 74th Cong., 2d Sess. (1936); S. Rep. No. 1502, 74th Cong., 2d Sess. (1936).

By passing the RPA Congress intended to eliminate competitive advantages attributable solely to the size or bargaining power of the large chains. As the Supreme Court stated in the *FTC v. Sun Oil* case,[2] "Congress intended to assure, to the extent reasonably practicable, that businessmen at the same functional level would start on equal competitive footing so far as price is concerned." The Act was structured to prohibit all discriminations in price for goods of "like grade and quality," except those "made in good faith to meet an equally low price of a competitor" or those which could be explicitly cost-justified.[3]

Throughout the nearly forty years of its existence, the Act has been the subject of continuing controversy. It is frequently argued that the effect of the Act is to protect small competitors rather than to promote efficient competition.[4] This result is criticized as inconsistent with the broad policies of the antitrust law in favor of vigorous price competition.[5]

More particularly, the concern is that the effect of a law prohibiting price discrimination could well be price inflexibility.[6] The need to price freely and flexibly in response to changing market conditions is of course vital to a competitive economy. But not all pricing schemes are pro-competitive in effect. Some forms of price discrimination, for example, are clearly injurious to competition, particularly at the buyer level. There is, then, at least a potential conflict between policies against price discrimination and those in favor of active price competition.

We will examine this conflict in the light of basic microeconomic theory and then propose a revision of the RPA that ameliorates many of its difficulties. In Section I, we present an economic critique of the current Act concluding that while it does have serious negative effects, it ought not be repealed out-

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2 FTC v. Sun Oil Co., 371 U.S. 505, 520 (1963).

3 15 U.S.C. § 13 (1970).

4 *See, e.g.,* Levi, *The Robinson-Patman Act—Is it in the Public Interest?* 1 A.B.A. ANTITRUST SECTION 60, 65 (1952).

5 *See generally* Report of the Department of Justice, Antitrust Division, Reform of the Robinson-Patman Act (July 9, 1975) [hereinafter cited as Justice Report]. The text of Justice Department's Robinson-Patman Act Reform Statute is reprinted in the Appendix to this Article. See text following note 230 *infra.*

6 *See* Shniderman, *The Impact of the Robinson-Patman Act on Pricing Flexibility,* 57 NW. U.L. REV. 173 (1962).

right. In Section II, we outline the basic economic underpinnings of our proposed revision of the RPA. Finally, we present a proposal for revising the Act.

I. The Robinson-Patman Act and the Concept of Price Discrimination

A. *The Robinson-Patman Act Summarized*

The RPA[7] was enacted in 1936 as an amendment to the Clayton Act.[8] The RPA has two prohibitory sections, Sections 1 and 3. The former takes the form of an amendment to Section 2 of the Clayton Act and is commonly referred to as Section 2 of the RPA.[9] The latter section provides criminal sanctions for some of the same prohibitions as Section 1 as well as a general predatory practices prohibition.[10] While Section 2 is the basis of many suits by the FTC,[11] Section 3 has rarely been used.[12]

Section 2(a)[13] makes it unlawful for a person "engaged in commerce" to discriminate in price[14] in sales of "commodities of like grade and quality" when the effect of such discrimination is to injure competition between sellers, buyers, or the customers of either. The section provides several exemptions from this prohibition. An otherwise unlawful price may be justified by cost savings to the seller or changes in the market for or marketability of the goods. Section 2(b) provides that a difference in price establishes a prima-facie case of a Section 2(a) violation which the defendant must rebut.[15] It also establishes a defense that the price

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7 Act of June 19, 1936, ch. 592, §§ 1, 3, 49 Stat. 1526, *amending* 15 U.S.C. § 13 (1970) (codified at 15 U.S.C. §§ 13, 13a (1970)).

8 Act of Oct. 15, 1914, ch. 323, 38 Stat. 730 (codified at 15 U.S.C. §§ 12, 13, 14-19, 20, 21, 22-27, 44 and 29 U.S.C. §§ 52, 53 (1970)).

9 15 U.S.C. § 13 (1970).

10 15 U.S.C. § 13a (1970).

11 By agreement, the Justice Dept. leaves the civil enforcement of RPA to the FTC. *Id.*

12 Justice Report, *supra* note 5, at 3.

13 15 U.S.C. § 13(a) (1970).

14 *See* text accompanying notes 20-36 *infra* for elaboration of price discrimination concept.

15 15 U.S.C. § 13(b) (1970).

was charged "in good faith to meet an equally low price of a competitor."

Section 2(c) prohibits payment of brokerage or discounts "in lieu thereof."[16] Sections 2(d)[17] and 2(e)[18] prohibit, respectively, the payment to customers for services of facilities furnished and the furnishing by sellers of services and facilities unless they are available on "proportionally equal terms" to all competing customers.

Section 2(f)[19] makes it unlawful for a person engaged in interstate commerce to knowingly induce or receive a discrimination in price prohibited by Section 2.

B. *The Concept of Price Discrimination*

Thus the RPA is designed to prohibit a wide variety of both direct and indirect types of price discrimination. However, it is difficult to provide an easy, all-inclusive definition of price discrimination. In general, price discrimination is the sale of separate units of a good or service at price differentials not directly matching differences in the supply costs of each good. For instance, price discrimination can include cases where (a) units of a good or service with equal supply costs are sold at different prices, or (b) units of a good or service with differing costs are sold at the same price.[20] Only in the former case, where there is an actual price differential, do the prohibitions of the RPA apply.[21]

Three basic conditions must be fulfilled if price discrimination is to be available to a seller.[22] First, the seller must possess some market power or, in other words, be able to control the product's price. Second, the seller must be able to separate his customers into classes of consumers with different "price elasticities of demand"[23] or with differing "reservation" prices.[24] Third, there

16 15 U.S.C. § 13(c) (1970).

17 15 U.S.C. § 13(d) (1970).

18 15 U.S.C. § 13(e) (1970).

19 15 U.S.C. § 13(f) (1970).

20 *See generally* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 253-72, 495-505 (1971).

21 Section 2(a) of RPA speaks of discrimination "in price."

22 *See* F. SCHERER, *supra* note 20, at 253.

23 This is a technical term which, intuitively, means the ratio of the percentage change in the quantity a consumer or class of consumers will demand divided by the percentage change in the price of the good which induces the change in demand. In short, the more or less responsive the quantity demanded is to changes in price, the higher or lower will be the price elasticity of demand.

must be no chance for arbitrage or, in other words, resale by low-price customers to high-price customers.

In short, price discrimination is a particular type of market conduct which can be practiced only by those sellers who possess market power as well as the ability to segregate their customers into appropriate classes and prevent arbitrage. While the necessary conditions for price discrimination to occur are fairly easy to delineate, the effects of price discrimination are a much more difficult matter. There are three basic "economic welfare" effects of price discrimination: (a) a redistribution of income from consumers to producers; (b) an ambiguous effect on allocative efficiency;[25] and (c) an effect on competition by affecting the market's structure and the choice of conduct by firms in the industry.

While it is clear that price discrimination does result in the redistribution of income from consumers to seller[26] it is difficult to describe this redistribution as a major harm of price discrimination since there is no way to demonstrate that it would be better to leave income in the hands of consumers than to allow sellers to expropriate it through price discrimination. Most academic economists, however, think that the former result is the most desirable.[27]

The ambiguity of the efficiency effect of price discrimination hinges not on any theoretical deficiency but rather on an empirical deficiency.[28] That is, in the most common form of price discrimination where the seller divides his customers into separate groups with different demand elasticities,[29] whether output will approach (increase to) the optimally efficient output under price discrimination is dependent upon the shape of the relevant mar-

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24 A "reservation" price is the highest price a buyer will pay for any specific unit of output. *See* F. SCHERER, *supra* note 20, at 253.

25 *See* note 37 *infra*.

26 *See* F. SCHERER, *supra* note 20, at 253-55.

27 *Id.* at 257-58.

28 However, it is important to note that the effects of price discrimination are analytically distinct from the allocative inefficiency of monopoly or oligopoly. The most basic tenet of microeconomic theory is that there will be less output sold at a higher price where the market is monopolistic or oligopolistic than if the market were perfectly competitive. *See* note 37 *infra*. The possible positive or negative effects of price discrimination are in addition to the consequences of the accumulation of market power by one or a few firms.

29 *Id.* at 254-55, 258-59.

ket demand functions. Although some have argued that price discrimination does have beneficial allocative efficiency effects in many cases,[30] a definitive statement about the overall allocative efficiency effects of price discrimination is impossible.[31]

Since the first two effects of price discrimination are difficult to assess unambiguously, they have not played a substantial role in the debate over possible repeal or reform of the RPA. Thus they will not be of central concern in the analysis that follows. However, the third effect, the effect on competition, is somewhat more manageable although complicated.

The harm and benefits to competition resulting from the practice of price discrimination can best be analyzed (as the courts have done in RPA cases) by distinguishing "primary-line effects" from "secondary-line effects."[32] The primary-line effect refers to the effect of discrimination on the competitors of the discriminator and the resulting effects on discriminator's market structure and conduct.[33] The secondary-line effects refer to the effect of the discrimination on the competitors of the favored buyer and the resulting effects on the buyer's market structure and conduct.[34] The courts have also extended the RPA's application to third- and fourth-line cases.[35]

The potential primary-line harms of price discrimination may take the form of a deleterious effect on industry structure or a dampening of interfirm price rivalry. At worst, the price discriminating tactics of a particular firm can, by drawing business away from a competing seller, force the exit of the competing seller (who may be equally or more efficient than the discriminator) from the market. In the more likely case, price discrimination or the threat thereof, will not force the exit of a competing firm but will lessen the incentive of other firms to compete with the price discriminator. On the other hand, allowing price discrimination may have the beneficial effect of encouraging selective price cuts by members of oligopolies thus tending to reduce the rigidity of oligopoly pricing.

30 *See* J. Robinson, The Economics of Imperfect Competition 204 (1933).
31 *See* F. Scherer, *supra* note 20, at 259.
32 Justice Report, *supra* note 5, at 7.
33 *See, e.g.,* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967).
34 *See, e.g.,* FTC v. Morton Salt Co., 334 U.S. 37 (1948).
35 *See, e.g.,* Perkins v. Standard Oil Co., 395 U.S. 642 (1969).

The harm of price discrimination to the secondary line is basically structural. That is, the concern at the secondary-line level is first whether a particular disfavored buyer is harmed and then whether this harm will hurt competition as a whole. Practically every instance of price discrimination harms the disfavored buyer at least slightly. However, whether the disfavored buyer's injury and possible exit from the market harm competition generally is a more difficult matter.

> The detrimental effect *on competition* at the secondary line resulting from a price discrimination will depend on (1) the competitiveness of the market in which the buyer resells the product, i.e., the number of buyers who obtain the lower price; (2) the portion of the buyer's total costs accounted for by the product in question; (3) the resiliency of the disadvantaged buyer's profit margins; and (4) the importance of the continued existence of the disadvantaged buyer as a competitive force in the relevant market. Without a thorough study of these factors it is not possible to predict with any certainty the amount of competitive harm at the secondary line resulting from a discriminatory pricing system.[36]

Thus the assessment of secondary-line injury is somewhat more difficult than that in the primary-line case. In fact, as discussed in the next section, price discrimination may in some cases encourage primary line competition while discouraging secondary line competition. In Section III, a possible resolution of this conflict will be suggested.

II. Economic Criticism of the Existing Act

There are at least two distinct but related respects in which the present Robinson-Patman Act may have undesirable economic consequences. First, it tends to deter sellers in oligopolistically structured seller's markets from cutting prices either on their own initiative or in response to buyer pressures.

Second, potential entrants to a particular market are denied use of the tactic of charging a lower price in the new market than they charge in their established markets, thus lessening their

36 Justice Report, *supra* note 5, at 8-9.

ability to attract business in the new market. In fact, they may be deterred from even attempting to gain a share of the new market.

A. *The RPA Encourages Price Inflexibility*

Perhaps the most severe anti-competitive effect of the current Act is that it encourages price inflexibility and oligopoly on the seller's side of the market. In an imperfectly competitive market, prices frequently are maintained at an artificially high level, and less of the good in question is produced than is socially optimal.[37] The Robinson-Patman Act, insofar as it discourages

37 The principle that where perfect competition does not exist, prices will be set at a level higher than ideal, and that less of the good will be produced than would be produced in a perfectly competitive market (*i.e.*, allocative inefficiency will result), is a central result of micro-economic theory. Although a full derivation of this principle is beyond the scope of this paper, the reasoning behind it may be summarized as follows.

Perfect competition is defined as the situation in which no producer possesses a sufficiently large share of the market such that he can have any substantial effect on the price of his commodity. Farm producers of corn, for instance, are probably engaged in near-perfect competition. Each producer of corn produces such a small percentage of the total that there is no way he could influence the market price. If the price were $.10 per ear, the farmer could not sell his corn at $.11 per ear. He would have no reason to sell for $.09 per ear, and if he did, his supply would be absorbed without affecting the market price in any measurable way. And he can sell as much output as he could ever produce at the market price of $.10, since even a great expansion of capacity on his part would not be enough to give him more than a very small share of the overall market.

Such a perfect competitor produces at a level of output such that his marginal cost equals the market price. This proposition is not self-evident, and requires some analysis as well as a definition of terms. Marginal cost is defined as the amount of out-of-pocket expenditure a producer would incur in increasing his production by one unit. See model statute § 16 *infra* for proposed operationalization of marginal cost concept. His marginal revenue is defined as the amount of revenue he would receive by selling that additional unit. Because the perfectly-competitive farmer can (by the definition of perfect competition) sell the extra unit without lowering his price, his marginal revenue from the extra sale equals the market price.

The producer's marginal cost usually varies as his level of output changes. Typically, his marginal cost decreases as his production goes from zero to a point near the capacity of his physical plant; then it begins to increase steadily as the producer strains his physical capacity.

That a producer in a perfectly competitive market will decide to produce at an output level at which his marginal cost equals his marginal revenue (which equals the market price) may be seen by considering the disadvantages to the producer of producing at any other level. If he produces at a level where his marginal cost is less than his marginal revenue, he will be earning lower profits than were otherwise possible. He could increase his production, since for each new unit of output he would be collecting marginal revenue greater than his marginal cost for producing that unit. Similarly, if he produces at a level where his marginal cost is greater than his marginal revenue, he will not be maximizing his profits. By cutting back production, he would save more in unexpected marginal cost than he would lose by foregoing his marginal revenue. The producer will thus select that seller initiated price cuts in many circumstances, reinforces the disadvantages of oligopoly.[38]

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level of output where his marginal cost equals his marginal revenue, which equals the market price. The selection of a level of output where marginal cost equals market price is characteristic of all producers who are engaged in perfect competition.

On the other hand a firm with monopoly power (either a true monopolist, or an oligopolist, *i.e.*, a producer sharing monopoly power with a small number of other firms) will not produce at a level at which his marginal cost equals the market price. He will, like the perfect competitor, choose a level of output at which his marginal cost equals his marginal revenue. His marginal revenue, however, will not equal the market price, but will instead be lower than the market price. The fact that the marginal revenue of the producer with monopoly power is lower than market price may be seen as follows.

By the very definition of monopoly power, a producer possessing it has captured a sufficiently large share of the market such that by varying his output, he can influence the market price, and conversely, in order to sell more units, he must lower his price. Consider first the true monopolist, that is, one who is the only producer in his particular market. He is, of course, the sole determiner of the market price, since he is the sole supplier. Suppose that if he sets his price at $10 per unit, he will be able to sell 100 units per week. If he wishes to increase his sales, the only way he can do so is by lowering his price. Thus to go from 100 unit sales to 101 units, he must drop his price from $10 to, say, $9.95. If he does so, his marginal revenue from the sale of the additional unit will not be the full $9.95, because he will have to charge the first hundred customers a nickel less than if he were selling at the $10 level (unless he is able to price-discriminate, a possibility which is not considered at this point in the analysis). His marginal revenue from increasing his production from 100 to 101 will therefore be only $4.95 ($9.95 from the new purchaser minus 100 times the nickel lost from the earlier purchasers).

The monopolist's marginal revenue is therefore always less than the market price at that level of sales. This is different from the case of the producer engaged in perfect competition, since the latter can by definition increase his sales without dropping his price; the perfect competitor's marginal revenue is, as was seen above, equal to the market price.

The monopolist will, like the perfect competitor, produce at a level of output such that his marginal revenue will equal his marginal cost. However, as was seen above, at any given level of production the selling price will be greater than marginal revenue. Thus the monopolist's price for a given product will be higher than the price for that product would be if produced by a perfect competitor, assuming that the monopolist and perfect competitor have the same costs of production. Similarly, the monopolist's level of output will be lower than if he were a perfect competitor. This follows from the fact that the price he sets is higher than the price would be in the perfect competition case.

In summary, the monopolist will charge higher prices than the perfect competitor, and will produce less. A consequence of this is that consumers who would have been willing to pay the perfect competitor's price, but not the monopolist's higher price, will be deprived of the product. And since the perfect competitor's price would have been equal to his marginal cost of production consumers who would have met the perfect competitor's price but not the monopolist's price are deprived of a good whose marginal cost of production they would have been willing to pay. This result constitutes a loss of social utility. *See generally* C. FERGUSON, MICROECONOMIC THEORY (3d ed. 1972).

38 *See generally* W. SHEPHERD, MARKET POWER AND ECONOMIC WELFARE (1970); F. SCHERER, *supra* note 20.

This price inflexibility is exacerbated by the possibility that the favored buyer will also be open to sanctions under the Act.[39] Just as Section 2(a) may dissuade sellers from lowering their price,[40] the spectre of liability under Section 2(f) may dissuade buyers from hard bargaining, and continued oligopolistic pricing will be fostered.

A former FTC Commissioner has described the virtues of allowing an individual buyer the right to bargain for lower prices in a seller's oligopoly:

> [P]rice differences will naturally arise from the ordinary pressures of everyday bargaining and haggling in a competitive market. A price discrimination law which results in the elimination of such pressures would impair or obstruct the competitive process. Especially in a seller's market that is oligopolistically structured, the ability of a few buyers to obtain lower prices may be the only way in which a general reduction of prices in such a market can come about. In short, there is a compelling need to distinguish between those discriminations in price which may injure competition and those which reflect active and vigorous pressures of competition and which are a necessary concomitant of a healthy competitive system.[41]

An additional respect in which price inflexibility may be promoted by the Act results from the possibility that a seller may be liable for anti-competitive effects suffered by the customers of his customers.[42]

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39 Such sanctions against the favored buyer are provided by § 2(f), which states that "[i]t shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section." 15 U.S.C. § 13(f) (1970).

40 15 U.S.C. § 13(a) (1970).

41 Elman, *The Robinson-Patman Act and Antitrust Policy: A Time for Reappraisal*, 42 WASH. L. REV. 1, 9 (1966). The negative effect of the Robinson-Patman Act on pricing flexibility is also discussed in Shniderman, *supra* note 6.

42 The Act prevents price discrimination "where the effect of such discrimination may be . . . to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them." 15 U.S.C. § 13(a) (1970). The manner in which this language may impose liability on a seller for harm suffered by the competitors of his customers' customers may be sketched as follows.

Consider the case of Seller who grants a lower price to Buyer A than to Buyer B, where Buyer A and Buyer B are both wholesalers. Suppose that Buyer A resells only to retail affiliates, at a lower price than Buyer B can sell to its retail customers.

However, the Act's applicability to third and fourth level competitive injury is not necessarily economically undesirable. In fact, there are several contexts in which the Act's effects are economically advantageous.[43] However, the extension of the Act to third and fourth level effects may in some instances contribute to high prices on the third and fourth level, and even to resale price maintenance.[44]

A corollary of the price inflexibility promoted by the RPA is the perpetuation of inefficient firms in the seller's market. Because prices are kept artificially high, inefficient firms are permitted to survive. If the most efficient firm in an industry prices above its marginal costs, less efficient firms may be able to match the price of the efficiency leader, without going below their own marginal costs. However, in markets where barriers to new entry are high, inefficient firms may provide a restaining influence on the pricing conduct of oligopolists or would-be monopolists who might, in the absence of both relatively efficient and inefficient competitors, raise their prices closer to the monopolist's profit

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If Buyer B's retail customers are unable to compete effectively with Buyer A's retail customers, Buyer B's customers may have a Robinson-Patman claim not only against Buyer B, but against Seller. Seller's original price discrimination may have, in the words of § 2(a), "injure[d] . . . competition with [a] person who either grants or knowingly receives the benefit of [the] discrimination, or with customers of either of them." Buyer A is the person receiving the discrimination, and competition in his customers' market has been injured. The Act's sanctions can therefore apply to Seller. This result may be referred to as the "third level effect" of the Act. In Perkins v. Standard Oil Co., 395 U.S. 642 (1969), the Supreme Court held a seller liable for "fourth level" competitive injury stemming from his price discrimination; that is, the seller was held liable for the fact that competition with his customer's customer's customer was impaired.

43 *See* text accompanying notes 109-14 *infra*.

44 *See* Justice Report, *supra* note 5, at 18. This possibility may be illustrated by again referring to the case of Seller. If Seller knows that he may be held liable for injury to competitors of Buyer A's customer, he may police Buyer A's pricing practices, to keep him from price discriminating. This will result in Buyer A's charging higher prices to the third level than he otherwise would, and price inflexibility will be promoted on the first, second, and third levels. Furthermore, the most efficient way for Seller to police Buyer A's pricing practices might be by imposing a resale price maintenance agreement on Buyer A, a result in contravention of § 1 of the Sherman Act. *See, e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911). Seller might engage in such policing tactics even if he believes that his own price differential is lawful. As long as there is a possibility that he may be held liable for third, fourth, and possibly even fifth level effects, he may decide that the safe policy is to police his customers rather than risk liability.

maximizing level. Thus, the aggregate competitive effect of this corollary is somewhat unclear.[45]

B. *RPA Thwarts Entry*

The second major difficulty with the Robinson-Patman Act is that it frequently acts to thwart entry into a particular geographic market. Consider the case of a producer who is currently doing business only in geographic market A. If he is to enter market B successfully, in which several firms have entrenched market shares, he must be able to adopt some market strategy which will offset the natural advantages of the entrenched firms in order to capture a sufficient market share. Promotional pricing is one such strategy. It involves charging a "temporary, low price designed to induce patronage with the expectation that the customer will continue purchasing the product in the future at a higher price."[46]

If the entering producer is able to charge only the same price in market B as he charges in market A, he may be unable to attract business in market B, due to "the inertia of established trade relationships,"[47] even if he charges the same as the established producers in market B. Yet the RPA prevents precisely this type of geographic price-differential, even though no secondary-line injury occurs.[48]

The manner in which the RPA may deter new entrants is vividly demonstrated by *Utah Pie Co. v. Continental Baking Co.*[49] The plaintiff in that case, the Utah Pie Co., operated only in the Salt Lake City area, but enjoyed a 67% share of the Salt Lake City market for frozen pies. Several pie producers[50] with large operations in other markets attempted to augment their small Salt Lake City market shares by embarking on a price-cutting campaign. Each of these out-of-state producers charged a uniform, non-discriminatory price within the Salt Lake City area,

45 *See* note 37 *supra.*

46 Areeda and Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act,* 88 HARV. L. REV. 697, 713 (1975).

47 White House Task Force Report on Antitrust Policy, BNA-ATTR No. 411, at 9 (1969) [hereinafter cited as "Neal Report"].

48 *See, e.g.,* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685, 693 (1967).

49 *Id.*

50 Continental Baking Company, Carnation Company, and Pet Milk Company. *Id.* at 687.

but a lower price than in their home market. The Supreme Court held that this conduct constituted a violation of the Robinson-Patman Act, despite the fact that the plaintiff increased its sales volume and continued to make a profit over the price-cutting period. In fact, the plaintiff maintained a 45% share of the market after the price-cutting period.[51]

The Court in *Utah Pie* considered the relation between price and costs only with respect to one of the several defendants. That defendant, Continental, charged a Salt Lake City price that was "less than its direct cost plus an allocation for overhead," that is, a price less than its average total cost. There was no evidence that Continental charged less than its marginal cost, that is, that it took an "out-of-pocket" loss on its Salt Lake City venture.

Prospective market entrants may rightfully draw a chilling lesson from *Utah Pie.* The rule of that case seems to be that a producer may not enter a new market and charge less for his product than he charges in another market, even if he keeps his price above his marginal cost, and even if he does not prevent the established producers in the new market from making a profit. To the extent that new entrants are discouraged from attempting entry, relatively inefficient firms will continue to survive, and prices will tend to remain high.

C. *The Robinson-Patman Defenses*

The economic disadvantages discussed above are exacerbated by the difficulty of establishing certain defenses which the RPA permits. Among the most important defenses available to a Robinson-Patman defendant are: (1) that competition was not seriously affected by his actions; (2) that the price differential was cost-justified, and therefore permitted by the proviso to Section 2(a); and (3) that he made a good faith effort to meet, but not beat, the lawful price of a competitor. Significant obstacles impede the successful assertion of each of these defenses.

51 The Court's conclusion may have been in part influenced by what it inferred to be predatory intent on the part of the defendants. *Id.* at 702. The Court noted that one of the defendants made use of an industrial spy. *Id.* at 697. The Court also appears to have been influenced by the fact that the price cuts contributed to a "drastically declining price structure." *Id.* at 703.

1. The Defense That Competition Was Not Affected

The RPA does not sanction all price discrimination, but only that which has certain kinds of anti-competitive effects listed in Section 2(a). One of the varieties of discrimination which is outlawed is that which substantially lessens competition or whose effect "may be . . . to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them. . . ."[52] A literal reading of this language implies that any discrimination which causes injury to a single competitor of either the seller, the favored buyer, or the favored buyer's customer, may be sufficient to trigger the Act's sanctions. This literal interpretation has been characterized as the "diversion of business" test — if the discrimination diverts business from anyone, the Act applies, even if the overall effect of the discrimination is to break down oligopoly and to promote competition in the broad sense.

Although the strict "diversion of business" test at the primary level has been discredited generally,[53] its effects linger on in the Second Circuit,[54] in the FTC,[55] and, in various guises, in the Supreme Court.[56] The diversion of business test has also been a

52 15 U.S.C. § 13(a) (1970).

53 *See* Anheuser-Busch, Inc. v. FTC, 289 F.2d 835 (7th Cir. 1961). In rejecting the strict diversion of business test, the Seventh Circuit said in Anheuser:

> The Act is really referring to the effect upon competition and not merely upon competitors. . . . In this respect § 2(a) must be read in conformity with the public policy of preserving competition, but it is not concerned with mere shifts of business between competitors. It is concerned with substantial impairment of the vigor or health of the contest for business, regardless of which competitor wins or loses. The competition which is sought to be protected by this section is a contest between sellers for the buyer's business, because 'competition is, in its very essence, a contest for trade.'

Id. at 840. *See also* Minneapolis-Honeywell Regulator Co. v. FTC, 191 F.2d 786, 790 (7th Cir. 1951), *cert. denied,* 344 U.S. 206 (1952); Shore Gas and Oil Co. v. Humble Oil & Refining Co., 224 F. Supp. 922, 926-27 (D.N.J. 1963) (no causal connection between the price discrimination and plaintiff's injury); A.E. Staley Manufacturing Company v. Federal Trade Commission, 135 F.2d 453, 455 (7th Cir. 1943); *In re* General Foods Corp., 50 F.T.C. 885, 890 (1954).

54 *See, e.g.,* Samuel H. Moss, Inc. v. FTC, 148 F.2d 378 (2d Cir. 1945), *cert. denied,* 326 U.S. 734 (1945).

55 *See* Justice Report, *supra* note 5, at 12. *See, e.g.,* Dean Milk Co., 68 F.T.C. 710, 750 (1965), *rev'd,* 395 F.2d 696 (7th Cir. 1968).

56 *See, e.g.,* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 *et seq.* (1967) ("[t]he Act reaches price discrimination that erodes competition as much as it does

factor in secondary line injury cases.[57]

Assertion of the defense that no competitive injury resulted is rendered still more difficult by language in Section 2(a) which appears not to require that the injury actually have occurred. Section 2(a) outlaws discrimination whose effect "*may be* . . . to injure, destroy, or prevent competition. . . ."[58] By a literal interpretation of this language, a court could find an RPA violation where no actual competitive injury has so far occurred, if the court finds that the defendant's conduct *may* lead to competitive injury. Thus the FTC may terminate a scheme in its incipiency, before it has actually had anti-competitive effects, if the Commission finds that such effects are likely to follow.[59]

The possibility that the Act has been violated merely because competitive injury may occur in the future gives the courts and the FTC a means of returning to the "diversion of business" test. A Robinson-Patman plaintiff may be able to show that he has lost customers through the defendant's price discrimination, but may be unable to show that competition in the seller's market has generally suffered. But if the plaintiff can show that there is some possibility that he may in the future be driven out of business if defendant's discrimination is allowed to continue, the court will be able to find a violation of the Act without the necessity of holding that the diversion of business from the plaintiff is itself competitive injury.[60] In any case, the seller may refrain from

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price discrimination that is intended to have immediate destructive impact." *Id.* at 703.).

57 *See, e.g.,* FTC v. Morton Salt Co., 334 U.S. 37 (1948). *But see* American Oil Co. v. FTC, 325 F.2d 101 (7th Cir. 1963), *cert. denied,* 377 U.S. 954 (1964).

58 15 U.S.C. § 13(a) (1970) (emphasis supplied).

59 *See* Justice Report, *supra* note 5, at 16-17. The possibility for penalizing discrimination which has not yet had anti-competitive effects, but may, is indicated by dictum in Forster Mfg. Co. v. FTC, 335 F.2d 47 (1st Cir. 1964). The Court's test for determining whether a violation of the Act had occurred was that "[i]t is enough to show violation of the Act if it is 'reasonably possible,' . . . that price discrimination 'may' [injure competition]." *Id.* at 54. *See also* National Dairy Co. v. FTC, 412 F.2d 605 (7th Cir. 1969); FTC v. Morton Salt Co., 334 U.S. 37 (1948); Corn Products Refining Co. v. FTC, 324 U.S. 726 (1945).

60 *See, e.g.,* Corn Products Co. v. FTC, 324 U.S. 726, 742 (1945); FTC v. Morton Salt Co., 334 U.S. 37, 47 (1948) (Showing ". . . [t]hat [Morton's] quantity discount did result in price differentials between competing purchasers sufficient in amount to influence their resale price of salt . . . in itself is adequate to support . . . finding that the effect of such discriminations 'may be substantially to lessen competition

commencing his differential pricing scheme altogether rather than risk having to defend a court suit brought even before any competitive injury occurs.

2. The Cost-Justification Defense

The first proviso to Section 2(a) of the Act states that "... nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."[61] The defense that price differentials solely reflect cost differences has become known as the "cost-justification defense." Because the successful assertion of the defense generally requires an elaborate statistical showing, and the standards for such a showing are unclear,[62] the defense is frequently unworkable.

The primary difficulty with asserting the cost-justification defense is that the courts have required costs to be calculated with respect to fairly narrowly-defined classes of customers.[63] A seller with a large number of purchases is virtually never able to calculate his costs separately for each customer with whom he deals. He may, however, be able to calculate his costs for dealing with each of several classes of customers. For instance, he may be able to ascertain that his average cost for dealing with purchasers of more than 1000 units per week is x, and his average costs for dealing with purchasers of less than 1000 units per week is $x + y$. The degree of breadth permitted in the definition of classes will in large measure determine the viability of the cost-justification defense.

The courts have permitted greater breadth in class-definition during the last ten or fifteen years than had been the case previously,[64] but the difficulties in successfully asserting the cost de-

... and to injure, destroy, and prevent competition.") *But see* American Oil Co. v. FTC, 325 F.2d 101 (7th Cir. 1963), *cert. denied,* 377 U.S. 954 (1964).

61 15 U.S.C. § 13(a) (1970).

62 *See generally* A. NEALE, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 234-37 (2d ed. 1970).

63 *See, e.g.,* American Can Co. v. Bruce's Juices, 190 F.2d 73 (5th Cir.), *cert. denied,* 342 U.S. 875 (1951). *But see* American Can Co. v. Russelville Canning Co., 191 F.2d 38 (8th Cir. 1951).

64 *See, e.g.,* FTC v. Standard Motor Products, 371 F.2d 613 (2nd Cir. 1967); American Motors Corp. v. FTC, 384 F.2d 247 (6th Cir. 1967), *cert. denied,* 390 U.S.

fense remain formidable. As the Supreme Court has observed, "proof of a cost justification being what it is, too often no one can ascertain whether a price is cost-justified."[65] The difficulties or defining classes in a sufficiently narrow manner are illustrated by *United States v. Borden Co.*[66] Borden, the defendant, established two general classifications for pricing purposes. One of these classes was composed of its two chainstore customers, A & P and Jewel. The other class consisted of all other, independent, customers; these independents were grouped in four sub-categories depending on their volume of purchases. The United States asserted that Borden had discriminated against all of the independents and that Borden's calculation of its costs by using the chain versus independent classification failed to establish the cost-justification defense, because the classes were too broad.

The Supreme Court agreed that the defense had not been established.[67] The Court noted that Borden's costs of dealing with the largest of the independents was closer to its cost of dealing with the smaller of the chains than it was to the cost of dealing with the smallest independent.[68] The Court cited an FTC opinion, to the effect that "[a] cost justification based on the difference between an estimated average cost of selling to one or two large customers and an average cost of selling to all other customers cannot be accepted as a defense to a charge of price discrimination."[69] The Court held that the cost-justification defense would be accepted only if there is "a close resemblance of the individual members of each group on the essential point or points which determine the costs considered."[70]

The difficulty of drawing classes with sufficient narrowness is accompanied by uncertainty as to exactly what costs must be considered in the cost-justification defense. It may, for instance, be

1012 (1968); and Morton v. National Dairy Prods. Corp., 414 F.2d 403 (3rd Cir. 1969), *cert. denied,* 396 U.S. 1006 (1970). The cost justification defense was successfully asserted in all of these cases.

65 Automatic Canteen Co. v. FTC, 346 U.S. 61, 79 (1953). *But see* Morton v. National Dairy Products Corp., 414 F.2d 403 (3d Cir. 1969), *cert. denied,* 396 U.S. 1006 (1970); American Motors Corp. v. FTC, 384 F.2d 747 (6th Cir. 1967), *cert. denied,* 390 U.S. 1012 (1968).

66 370 U.S. 460 (1962).

67 *Id.* at 462.

68 *Id.* at 469-70.

69 *Id.* at 470, *citing In re* Champion Spark Plug Co., 50 F.T.C. 30, 43 (1953).

70 *Id.* at 469.

difficult to determine whether a particular expenditure is a "cost" of the good sold for cost-justification purposes, or is instead part of capital investment. For example, suppose the seller builds a warehouse for servicing some customers, but other customers buy directly from the plant. May the seller justify charging a lower price to the buyers who purchase directly from the plant, by asserting that the capital invested in the warehouse has a "cost" of, say, eight percent per year[71] and that this cost must be allocated to the customer who uses the warehouse? The FTC has rejected such a cost justification, on the grounds that the interest value of the capital invested in the warehouse is "profit," not a paid-out "cost."[72] Yet it is not clear whether a court would agree, and the seller is left with the difficult task of deciding whether to charge a price differential without knowing what "costs" he will be able to assert as a cost-justification in the event that he is sued under the RPA. This difficulty, like the difficulty of drawing sufficiently narrow classes, makes the cost-justification defense seldom successful, and contributes to the economic disadvantages of the Act insofar as it encourages inflexible oligopolistic pricing.[73]

3. The Good Faith Defense

The defense perhaps most frequently, and most successfully, asserted by Robinson-Patman defendants is the "meeting competition in good faith" defense provided by Section 2(b).[74] That section provides that ". . . nothing herein contained shall prevent a seller rebutting [a] prima-facie case thus made by showing that his lower price . . . was made in good faith to meet an equally low price of a competitor. . . ."[75]

The courts at present require that three conditions be fulfilled before the meeting-competition defense may be asserted: (1) the seller must show that he exercised due diligence in verifying that

71 This assumes that eight percent is the interest rate charged to borrowers of capital.

72 *See* P. AREEDA, ANTITRUST ANALYSIS—PROBLEMS, TEXT, CASES 886-87 (2d ed. 1974). The FTC's result in such a case is criticized by Areeda. *Id.*

73 *See* text accompanying notes 37-45 *supra.*

74 15 U.S.C. § 13(b) (1970).

75 *Id.*

the lower price he is meeting was in fact offered; (2) the seller must attempt merely to meet, and not undercut, his rival's price; and (3) the seller must not meet prices which he knows or has reason to think are themselves unlawful. A brief consideration of each of these three requirements will illustrate some of the difficulties in administering the meeting-competition test as it has been interpreted under the present Act.

a. Due Diligence. — The FTC has frequently taken the position that a seller established that he exercised due diligence in confirming the existence of a rival's offer only if he obtained the identity of the rival as well as the amount of the price cut.[76] However, the courts have generally considered this to be unduly burdensome, and have usually, at the least, dispensed with the requirement that the seller procure the name of his rival.[77] The general test remains the one stated by the Supreme Court in *FTC v. Staley Mfg. Co.,* by which the seller asserting the meeting-competition defense must show "the existence of facts which would lead a reasonable and prudent person to believe that the granting of a lower price would in fact meet the equally low price of a competitor."[78]

Nonetheless, the courts have not agreed on exactly what kind of a showing is sufficient to meet the due diligence requirement. It has been held that the requirement is met where the buyer presents a copy of a competing seller's invoice or billing notice for the particular order in question.[79] Similarly, the requirement has been held satisfied where the buyer shows the seller a letter from a competing seller offering a lower price.[80]

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76 *See, e.g., In re* Forster Mfg. Co., 62 F.T.C. 852, 916 (1963), *rev'd,* 335 F.2d 47 (1st Cir. 1964), *cert. denied,* 380 U.S. 906 (1965). For a general discussion of the Commission's initial interpretation of "due diligence" as well as the judicial response, see Steele, *Section 2(b) of the Robinson-Patman Act — Rules for Meeting Competition in the Past and the Present,* 13 ANTITRUST BULL. 1223, 1254-69 (1968).

77 For instance, in Forster Mfg. Co., Inc. v. FTC, 335 F.2d 47, 56 (1st Cir. 1964), *rev'g, In re* Forster Mfg. Co., 62 F.T.C. 852 (1963), *cert. denied,* 380 U.S. 906 (1965), the First Circuit reversed the Commission's decision on the ground that requiring identification of the competing seller and the precise amount of his offer is an "unrealistic" burden. *Accord,* Callaway Mills Co. v. FTC, 362 F.2d 435, 441-42 (5th Cir. 1966); Jones v. Borden Co., 430 F.2d 568 (5th Cir. 1970). *But Cf.* Viviano Macaroni Co. v. FTC, 411 F.2d 255, 259-60 (3rd Cir. 1969).

78 324 U.S. 746, 759 (1945).

79 *See, e.g., In re* The Borden Co., 64 F.T.C. 534 (1962).

80 *See In re* Beatrice Foods Co., Inc., 68 F.T.C. 286, 306-07 (1965).

But the courts have been in dispute as to whether a seller shows due diligence in confirmation where he takes the buyer's word that the latter has received a lower offer. Thus a number of courts have held that statements by the favored buyers were sufficient in themselves to meet the verification requirements.[81] In *Viviano Macaroni Co. v. FTC,* however, the court held that the seller had not met this burden of verifying the lower offer's existence, merely by taking the buyer's word for it.[82]

Thus the duties of the seller in verifying the existence and source of a competing offer are unclear under present law. This lack of certainty probably has a tendency to discourage sellers from granting price concessions, and thus keeps prices in oligopolistic markets higher than otherwise would be the case.

A further disadvantage stemming from the present uncertainty as to what the seller must do to confirm the existence of a lower offer, is that interchange of price information among competitors will be stimulated. A seller who is uncertain whether he may legally rely on the buyer's word that a lower price has been received, may simply call the rival for confirmation.

In a perfectly competitive market, such inter-seller communication is desirable. In such a situation, information exchanges will help to achieve the efficient market equilibrium. The proper functioning of the price allocating mechanism is served by buyer awareness of the lowest cost source of supply as well as seller awareness of the demand conditions in the market.[83] This is the "perfect knowledge" assumption of the ideal competitive system.

Where the market is oligopolistic, however, just the contrary

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81 *See* Jones v. Borden Co., 430 F.2d 568 (5th Cir. 1970). *See also* Krieger v. Texaco, Inc., 373 F. Supp. 108, 112 (W.D.N.Y. 1973) and Cadigan v. Texaco, Inc., 492 F.2d 383 (9th Cir. 1974), in both of which uncontested affidavits from the favored dealers attesting that they had communicated reports of lower offers to Texaco were sufficient to support summary judgments in defendant Texaco's favor on Robinson-Patman charges.

82 411 F.2d 255 (3rd Cir. 1969). The court stated that:

> While we can again sympathize with the difficulty facing petitioner in finding precise information as to the identity of the competitors and the amount of offers, there is no indication in the record that Samuel Viviano did anything more than merely accept the word of the Fox official, William Kemper, as to there being competitive offers outstanding.

Id. at 259.

83 *See* Turner, *Cooperation Among Competitors,* 61 Nw. U. L. Rev. 865, 866 (1967).

may sometimes be true. Detailed information exchanges, especially those identifying parties in current transactions, may serve to frustrate competition in oligopolistic markets.[84] Such information exchanges may lead to joint profit-maximization by the oligopolists rather than independent pricing decisions. In markets dominated by a few sellers, a certain amount of ignorance concerning rivals' prices might actually serve as a pro-competitive force. If price is set artificially above marginal cost, each oligopolist has an incentive secretly to lower his price to capture a larger market share. This increased market share will be, at least in part (depending on the inelasticity of the market demand), at the expense of his fellow oligopolists. If the price cut is uncovered, however, it will probably be met by all the other sellers, and none of the oligopolists benefit. Hence, if reliable information is available concerning competitors' prices, the incentive to make a price cut is greatly diminished and the possibility of collusion is increased. But if such information is not available, then the oligopolists will be pressured to protect themselves against even suspected price cuts. This may result in a downward trend in prices.

The inter-seller communication stimulated by the present uncertainty as to the scope of the meeting-competition verification requirement, may also run afoul of other antitrust laws. In *United States v. Container Corp.*,[85] for instance, the Supreme Court held that the exchange of price information between oligopolists constituted a violation of Section 1 of the Sherman Act because of its predictably anti-competitive consequences. The logic of *Container* may well imply that in an oligopolistic market any exchange of information regarding current price quotations to identified buyers is illegal.[86]

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84 *See, e.g.*, E. CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION 46-52 (1948); C. KAYSEN & D. TURNER, ANTITRUST POLICY 150 (1959); F. SCHERER, *supra* note 20, at 143-44, 208-10, 246, 449-50, 521 (1971).

85 393 U.S. 333 (1969).

86 *See* Note, *The Supreme Court, 1968 Term*, 83 HARV. L. REV. 60, 233-35 (1969). *But see* Kefauver, *The Legality of Dissemination of Market Data by Trade Associations: What Does Container Hold?*, 57 CORNELL L. REV. 777 (1972), which interprets *Container* to require proof of anticompetitive effect in each case in addition to the information exchanged. Richard W. McLaren, head of the Antitrust Division of the Justice Department when *Container* was handed down, thought its message was clear:

In a post-*Container* decision, a California federal district court recognized an exception to Section 1 of the Sherman Act liability for sellers whose communications with their rivals were an attempt to verify the rival's lower offer so that the seller could meet it without incurring Robinson-Patman liability. That case, *Wall Products Co. v. National Gypsum Co.*,[87] has in general been followed, and an attempt to obtain verification for Robinson-Patman meeting-competition purposes has usually been recognized as being excepted from Section 1 of the Sherman Act.[88]

Although the *Wall Products* holding will, if followed, probably ensure that no firm which obtains price information from its rivals for meeting-competition purposes will be subject to liability under Section 1 of the Sherman Act, the economic disadvantages of such inter-rival communications, as described

> I doubt the Supreme Court's recent decision in *Container Corporation* has materially changed the advice that the antitrust bar has been giving to clients . . . 'Don't call up your competitor to check if he actually made the offer your customer claims to have received.' . . . [*Container*] stands for the proposition that such checking with competitors, where it has become a prevalent market practice, constitutes a violation of Section 1 of the Sherman Act. In a future case, on similar facts, I think we would have to give serious consideration to filing on the criminal side.

Address to the Antitrust Section of the A.B.A., McLaren, *Recent Cases, Current Enforcement Views, and Possible New Antitrust Legislation,* 38 ANTITRUST L.J. 211, 212.

87 326 F. Supp. 295 (N.D. Cal. 1971). For a thorough analysis of the *Wall Products* case from a practitioner's standpoint, see Eaton, *The Robinson-Patman Act: Reconciling the Meeting Competition Defense with the Sherman Act,* 18 ANTITRUST BULL. 411, 424-30 (1973). *See also* Note, *Price Fixing and the Robinson-Patman Act,* 50 TEXAS L. REV. 369 (1972).

88 A number of cases have accepted the *Wall Products* analysis. In Webster v. Sinclair Refining Co., 338 F. Supp. 248 (S.D. Ala. 1971), the court dismissed a Sherman Act § 1 suit brought by a former Sinclair dealer, alleging that Sinclair had participated in a price-fixing conspiracy. The court accepted Sinclair's defense that it was only participating in a price exchange scheme to comply with the verification requirement. *Id.* at 252. In Belliston v. Texaco, Inc., 455 F.2d 175 (10th Cir.), *cert. denied,* 408 U.S. 928 (1972), a similar action was brought against Texaco dealers. Again, the *Wall Products* exception was upheld. *Id.* at 182. Finally, in Gray v. Shell Oil Co., 469 F.2d 742 (9th Cir. 1972), *cert. denied,* 412 U.S. 943 (1973), the court refused to upset a jury verdict for defendant, Shell Oil Co., charged with violating Sherman Act § 1 by exchanging price information with other major oil companies in a gasoline price were in San Francisco. The central question, as framed by the court, was "whether Shell's price inquiries were made in connection with a plausible belief that it was conforming to its legal obligations [under the verification requirement]." *Id.* at 747. If this language is interpreted literally to imply that merely a "plausible belief" of conformity with the verification requirement constitutes a defense to a *Container*-type charge, then little is left of the *Container* holding.

above, may be considerable. To the extent that the present confusion regarding the kind of verification which will suffice to allow the meeting-competition defense encourages such communication, the Robinson-Patman Act encourages inflexible, oligopolistic pricing.

The disadvantages of inter-seller communications also result where *buyers* furnish definite proof that a particular competing seller has offered a particular price. Thus where a buyer proves the existence of a lower offer by producing an invoice or letter with the offeror's name and price on it, the anti-competitive effects are identical to those stemming from direct inter-seller communications.

Despite the disadvantages of compelling a seller to obtain direct evidence of a lower offer before he may use the meeting-competition defense, however, it must be noted that there are dangers in permitting too loose a verification requirement. If a seller is permitted, in all circumstances, to rely upon the unsubstantiated word of his customer that the latter has received a lower offer, the customer may "whipsaw" the seller by attesting to offers that have not been made. The purpose of such whipsawing, of course, would be to coax the seller into meeting a phantom offer. This in turn could lead to a series of discriminatory price cuts, a result which the due diligence verification requirement was designed to prevent. The reported cases indicate that "whipsawing" is not an unusual competitive technique.[89]

Nor are there at present any satisfactory legal safeguards to deter buyer misrepresentations.[90] Section 2(f) of the Robinson-

89 *See, e.g.,* Kroger Co. v. FTC, 438 F.2d 1372 (6th Cir. 1971), *cert. denied,* 404 U.S. 871 (1971); Colonial Stores, Inc. v. FTC, 450 F.2d 733 (5th Cir. 1971).

90 A seller who is induced into granting an unlawful price discrimination based on his buyer's misrepresentation may have a tort action against the buyer to recover the damages assessed against him. There are, however, two obstacles to this action for misrepresentation. First, the seller's reliance on the buyer's misrepresentation must be reasonable under the circumstances. But the fact that the seller's meeting-competition defense was presumably rejected in the Robinson-Patman action may, under a *Staley* reasonableness test, have already established that the reliance was not in fact justifiable. Second, if the buyer is found guilty of a violation of § 2(f) of the Robinson-Patman Act (making buyers who knowingly induce unlawful discriminations liable—*see* text accompanying notes 39-41 *supra*) arising out of this transaction, a jurisdictional rule against contribution among joint tortfeasors may be a barrier to the seller's action. *See generally* W. PROSSER, LAW OF TORTS §§ 50, 108 (4th ed. 1971).

Patman Act makes it unlawful for any person "knowingly to induce or receive a discrimination in price" prohibited by the Act. The Court in *Automatic Canteen Co. v. FTC* construed this section to mean that "a buyer is not liable under Section 2(f) if the lower prices he induces are either within one of the seller's defenses such as the cost justification or not known by him not to be within one of those defenses."[91] Thus a buyer might fraudulently induce a seller to price discriminate and yet escape liability if the seller's discrimination can be justified under the good faith defense.[92] Of course, if the seller is given broad latitude to rely on the buyer's word to establish a good faith defense, the pernicious circle is complete.

Thus in those situations in which the present Robinson-Patman Act permits the meeting-competition defense, there is a great need for a verification requirement which is clear, which does not require the contacting of competitors or the furnishing by a buyer of another seller's identity and price, but which also discourages buyers from misrepresenting the existence of offers which were never made.

b. Meeting but not Beating Competition. — The meeting-competition defense is intended only to allow the rival's price to be matched, not undercut. Thus a seller who deliberately charges less than the price to which he is responding may not assert the meeting competition defense.[93] However, sellers are not obligated to establish that their price cuts in fact exactly matched the prices of their competitors, so long as they can produce facts to

91 346 U.S. 61, 74 (1953).

92 *In re* Kroger Co. v. FTC, 438 F.2d 1372 (6th Cir. 1971), *cert. denied,* 404 U.S. 871 (1971), the Sixth Circuit departed from the *Automatic Canteen* construction of buyer liability under § 2(f). In *Kroger,* the Court affirmed an FTC decision which held *Kroger,* the buyer, liable under § 2(f) for knowingly inducing a discriminatory price cut, even though the seller, Beatrice Foods, was exonerated from § 2(a) charges on a meeting-competition defense. In upholding the § 2(f) count, the court emphasized Kroger's misrepresentation of a competing bid as a key factor. It is also significant that the Commission accepted Beatrice's § 2(b) defense, despite the absence of any evidence indicating that Beatrice had attempted to verify Kroger's statements. *See In re* Beatrice Foods Co. and the *Kroger* Co., Inc., 76 F.T.C. 719, 757-60 (1969), *aff'd,* 438 F.2d 1372 (6th Cir. 1971), *cert. denied,* 404 U.S. 871 (1971).

The Ninth Circuit has indicated its support of the *Kroger* analysis. *See* Cadigan v. Texaco, Inc., 492 F.2d 383, 386 n.2 (9th Cir. 1974) (dictum). *But see* Harbor Banana Distributors, Inc. v. FTC, 499 F.2d 395, 399 (5th Cir. 1974).

93 *E.g., In re* Lloyd A. Fry Roofing Co., 68 F.T.C. 271, 261 (1965); *In re* Forster Mfg. Co., 68 F.T.C. 191, 198 (1965).

justify a reasonable belief that the price cut was intended only to meet the equally low price of a competitor.[94]

This reasonableness standard has not given rise to many problems of administration, and does not measurably impair the functioning of the Act.[95]

c. Meeting an Unlawful Price. — It is universally accepted that if a seller believes, and reasonably so, that the price he is meeting was lawfully charged, a subsequent judicial determination that the price met was in fact unlawful does not vitiate the meeting-competition defense.[96] The courts are in dispute, however, as to whether the defense is vitiated if the seller meets what he knows to be an unlawful price, or if his belief that the price he is meeting is lawful is unreasonable.

It is probably safe to say that a seller will be allowed the meeting-competition defense by most courts if he believes that he was meeting a lawfully-charged price, even if his belief was unreasonable. Thus in *National Dairy Products Corp. v. FTC*,[97] the court reasoned that the lawfulness test was intended to prohibit a seller only from meeting prices "that he knows to be illegal or that are of such a nature as to be inherently illegal."[98] Since the lower prices which National Dairy met were not "plainly illegal," the meeting-competition defense was permitted.[99]

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94 *See, e.g.,* Balian Ice Cream Co. v. Arden Farms Co., 231 F.2d 356 (9th Cir. 1955); Callaway Mills Co. v. FTC, 362 F.2d 435, 443 (5th Cir. 1966); National Dairy Products Corp. v. FTC, 395 F.2d 517, 523 (7th Cir.), *cert. denied,* 393 U.S. 977 (1968). *See also* the Report of the Attorney General's National Committee to Study the Antitrust Laws (1955), which noted:

> An incidental undercutting of the prices quoted by others, when in the course of genuinely meeting one particular competitor's equally low price offer . . . should not invalidate a seller's defense.

Id. at 183. *But see* Hampton v. Graff Vending Co., 478 F.2d 527, 535 (5th Cir. 1973), *cert. denied,* 414 U.S. 859 (1973), and *In re* Exquisite Form Brassiere, Inc., 64 F.T.C. 271, 284 (1964), *aff'd,* 360 F.2d 492 (D.C. Cir. 1965), *cert. denied,* 384 U.S. 959 (1966), both holding that evidence of actual underpricing would be relevant to whether the defendant used good faith in attempting to meet competition.

95 *See generally* F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON PATMAN ACT 240-55 (1962).

96 *See, e.g., In re* Knoll Associates, Inc., 70 F.T.C. 311, 417 (1966).

97 395 F.2d 517 (7th Cir.), *cert. denied,* 393 U.S. 977 (1968).

98 *Id.* at 524. This test was first articulated in Standard Oil Co. v. Brown, 238 F.2d 54, 58 (5th Cir. 1956) and has been recently cited with approval in Cadigan v. Texaco, Inc., 492 F.2d 383, 387 (9th Cir. 1974).

99 395 F.2d at 524.

In *Callaway Mills Co. v. FTC*,[100] the Fifth Circuit took the further step of allowing a meeting competition defense without regard to the apparent illegality of the prices being met, evidently because the FTC had not passed on the issue.

A relatively strict unlawfulness test would have the same ill effects as an unduly strict verification test. For instance, a test which requires the seller to show that he reasonably believed the price he was meeting to be legally charged would probably encourage inter-rival communications, and would keep prices high by discouraging selective price cuts. Too loose a requirement, however, might in some cases injure secondary line competition, and thwart the policies of the Robinson-Patman Act.[101] The quandary is a difficult one, and in our proposed revision, we resolve it by allowing a seller to meet even a price which he knows to be illegal, if the other conditions imposed by our proposal for the meeting-competition defense (which are quite strict) are met.[102]

In addition to the three requirements for the meeting-competition defense described above, the courts have rejected several others which had been advocated by the FTC. For example, the FTC view that the meeting-competition defense is available only for retaining old customers and not for gaining new ones, has been rejected.[103] Similarly, the FTC position that the seller cannot meet a competitor's "system" of price discrimination, but can only respond to ad hoc low prices by the rival, has been limited.[104]

Despite the fortunate abandonment of these two requirements, enough uncertainty remains about the meeting-competition defense that the economic disadvantages which would result if the

100 362 F.2d 435 (5th Cir. 1966).

101 For example, this may be true of those cases in which allowing the meeting-competition defense would increase secondary line injury. For a discussion of the circumstances in which allowing the meeting-competition defense would add to the secondary-line injury already caused by the first unlawful offer, see text accompanying note 203 *et seq. infra.*

102 *See* model statute §§ 4, 6 *infra.*

103 Sunshine Biscuits, Inc. v. FTC, 306 F.2d 48 (7th Cir. 1962), *rev'g* 59 F.T.C. 674 (1961).

104 Callaway Mills Co. v. FTC, 362 F.2d 435 (5th Cir. 1966), *rev'g* 64 F.T.C. 732 (1964).

RPA's prohibition on price discrimination were absolute, remain substantial.

D. *Advantages of the Present Act*

None of the above criticisms of the economic effects of the Act is intended to imply that the Act does not in some cases serve a useful function. Indeed, the chief purpose of the revision of the Act suggested here is to preserve the desirable features of the Act, and to eliminate only those applications of the Act which cause more harm than good. An analysis detailing the contexts in which the Act is useful, and those in which it is not, will be presented in Section II of this paper. For the moment, it will suffice to set forth in a general way some cases in which the Act performs a useful economic function.

1. Primary-Line Injury Prevented by the Act

"Primary-line injury" has been defined as injury to the vitality and competitive capability of the competitors of the price-discriminating seller.[105] There are two principle respects in which the Act, by preventing price discrimination, has beneficial effects at the primary line.

The first respect in which the Act may have beneficial economic effects at the primary line is that it may prevent a seller from destroying equally or more efficient competition.

Suppose that Seller A is a less efficient producer than Seller B. That is, A faces, perhaps due to inadequacies of personnel or plant, higher production costs than B. Now suppose that Seller A wishes to steal B's customers by charging them lower prices than they have been receiving from B. A wishes to do this while continuing to charge his previous, higher, price, to persons who are not customers of B. If A is allowed to pursue this scheme, he may succeed in driving B out of business, even though B is actually a more efficient producer than A. Of course, to pursue this course, A will have to drop his price so low that B cannot compete effectively. Since by hypothesis B has lower marginal

105 *See* text accompanying note 33 *supra.*

costs than A, A will be able to drive B out of business only if A drops his prices to B's customers below A's own marginal costs. If he does so, he will take an out-of-pocket loss on the sales to these favored customers, since by the definition of marginal cost he is receiving less for each additional unit sold than that unit cost him to produce.[106] He would not find it rational to pursue this course indefinitely, but if A has greater staying-power than B and if the barriers to new entrants to the market are substantial, A's scheme may work. Consequently, the more-efficient B may be driven out of business by A's selective price cuts. Even if B is not driven out of the market by A's pricing tactics, "the more frequent effect [of the discrimination] is the less visible one of chilling competitors' incentives to challenge the prices of the discriminator."[107]

The RPA will in many circumstances prevent both of these results. The Act does not prevent Seller A from dropping his price to all customers below his marginal costs, but it does prevent him from dropping only the price charged to Seller B's customers. Because such across-the-board price cuts will be more expensive for Seller A, he may decline to pursue the scheme altogether if he cannot make selective price cuts and, consequently, the more efficient Seller B will remain in business. Thus the Act will have had a positive economic result.

2. Secondary-Line Injury Prevented by the RPA

"Secondary-line injury" is injury suffered by competitors of a buyer who receives favorable prices from a price-discriminating seller.[108] The RPA, insofar as it was originated to protect the small grocery stores from extinction at the hands of the large chains which could exact lower prices from their suppliers, was designed to prevent secondary line, not primary line, injury.[109]

The prevention of secondary line injury is desirable in two distinct ways, one of which is purely economic and efficiency-oriented, and the other more or less social or "equitable."

106 *See* note 37 *supra* for discussion of why marginal cost pricing is profit maximizing.

107 Justice Report, *supra* note 5, at 8.

108 *See* text accompanying note 33 *supra.*

109 *See generally* F. ROWE, *supra* note 95, at 11-23 (1962).

First, if a seller is allowed to charge different prices to one customer than to another, the most efficient competitor in the customer's market may be driven out of business. Consider a single Seller, who has two customers, Customer 1 and Customer 2. Customer 1 is a moderately large, but not particularly well-run, retailer. Customer 2 is a small, but quite efficient, retailer who competes with Customer 1. Because Customer 1 is larger than Customer 2, he buys more of Seller's product, and enjoys a comparable superiority of bargaining power. If he is allowed to utilize this superior bargaining power in a completely untrammeled way, he may be able to exact a lower price from Seller than Customer 2 can, even though it does not cost Seller any more to sell a unit to Customer 1 than to Customer 2.

If Customer 1 obtains this lower price, he will be able to sell in turn to his customers at a lower price than could Customer 2. The difference may in fact be so substantial that Customer 1 will drive Customer 2 out of business, or at least induce Customer 2 to stop selling that particular product. But by our hypothesis, Customer 2 was in fact a more efficient competitor than Customer 1. That is, Customer 2's costs of handling the product once he obtained it (e.g., his salaries, rent, and utilities) are lower than those of Customer 1, because of superior management. But because Customer 1 is able to make his purchases at a lower price, an ability which is not related to any superiority of management but due instead solely to greater bargaining power, the more-efficient Customer 2 may be obliterated.[110]

Observe that Customer 1 will be able to exact lower prices than Customer 2 only if the market in which Seller competes is imperfectly competitive. If perfect competition exists in Seller's

110 The pervasiveness of scale economies would tend to indicate that a well-run moderately large retailer (Customer 1) would be more efficient, in a purely technical sense, than an equally well-run small retailer (Customer 2). However, by preventing Customer 1 from exerting his bargaining power to exact selective, favorable price cuts, the Robinson-Patman Act forces Customer 1 to squeeze out the laxness in his management operations, thus realizing the inherent technical efficiency in his operation. This "laxness" in management has been labelled as x-inefficiency as contrasted to technical economic inefficiency. Leibenstein, *Allocative Efficiency vs. 'X-Efficiency,'* AM. ECON. REV., June, 1966, 392-415. *See generally* F. SCHERER, *supra* note 20, at 72-103 on the question of the pervasiveness of economies of scale in the American economy.

market, each seller is a price "taker" and price discrimination is impossible.

Where Seller and his competitors are oligopolists, however, it is only the larger users, such as Customer 1, who will have the blackmail power to induce Seller to lower his prices, by threatening to patronize Seller's competitors. Seller must take a harder line vis-à-vis Customer 2, since Seller's financial loss will be smaller if he loses Customer 2 than if he loses Customer 1, and thus Seller will be more willing to risk the former loss in order to maintain price discipline.

The result of this is that if Seller's market is imperfectly competitive, Customer 1, solely because he is larger and therefore is able to induce price breaks from Seller, will be able to sell more cheaply, and drive Customer 2 out of business despite the fact that Customer 1 is less efficient. The relative seriousness of the loss of Customer 2 to this market varies directly with the barriers to entry to the market and indirectly with the vigor of the remaining competitors of Customer 1.

Because the Robinson-Patman Act prevents Seller from charging a different price to Customer 1 than to Customer 2, this entire process whereby the smaller but more efficient Customer 2 would be driven out of the market, is rendered less likely.

In addition to the greater economic efficiency realized by preventing the smaller but more efficient buyer from being obliterated, the Act might also preserve small *in*efficient customers who might have been driven out of the market just as, by the above analysis, small efficient customers might have been driven out. This demise of small but inefficient producers would not be undesirable from the standpoint of pure economic efficiency, except insofar as it removed a restraint on oligopolists' pricing conduct.[111] However, some believe that this demise of small producers offends the traditional American ideal of the small entrepreneur.[112] The draftsmen of the Robinson-Patman Act presumably realized that in some instances they might be protecting the small inefficient business which could not compete with larger, better-organized competitors enjoying economies of

111 *See* Section II(A) *supra.*

112 *See* text accompanying note 1 *supra.*

scale, but they implicitly concluded that protection of small businesses was an end worth achieving in itself, apart from any large-scale economic benefits.[113] Today, when industrial concentration has proceeded to a degree scarcely dreamt-of when the Act was originally passed, the social and moral desirability of protecting the small inefficient business may be even stronger. However, the revisions proposed do not "legislate" the preservation of small business. Rather, there are several aspects of the revisions which may lead to the preservation of small and relatively efficient producers.[114]

III. Economic Analysis of the Proposed Revision

The preceding section of this paper has set forth, in general terms, the economic advantages and disadvantages of the current Robinson-Patman Act (RPA). It is difficult to assess the relative advantages and disadvantages given the dearth of empirical data on the subject. But, to a large extent, it is possible to place competitive situations into a number of distinct categories, and to conclude that the RPA performs a useful function with respect to some of these categories and harmful effects with respect to others. The present section analyzes the most important categories, and demonstrates that the proposed revision performs a useful function far more often than the present Act, while reducing the harmful effects to a minimum.

The first category considered is that in which the seller does not price-discriminate, but reduces his prices across-the-board. We conclude that such conduct should be allowed only if the seller prices at or above his marginal cost, or if he is a small competitor pursuing a temporary promotional pricing strategy or responding to a low price set by a rival.

The second category is that of a seller who price-discriminates on a purely geographic basis. All customers in a given market are charged the same price, although the price varies from market to market. The conclusion is the same as in the first category: the

113 *Id. See generally* F. Rowe, *supra* note 95, at 19-23.
114 *See* Section III *infra.*

pricing conduct should be allowed only if it is at or above the seller's marginal cost, or if it is a below-marginal-cost price charged by a small seller employing promotional pricing or responding to a rival's price.

The final category considered is that of the seller who price-discriminates within a particular market, that is, who charges one customer less than a second customer competing with the first. In this situation, the analysis concludes that no discrimination, whether involving above marginal-cost or below-marginal-cost pricing, should be allowed. Again the small seller is granted an exception to pursue promotional pricing, but his privilege to price below marginal cost to meet a rival's price is no longer absolute.[115]

A. *Pricing in the Absence of Price Discrimination*

Section 2 of the Robinson-Patman Act has no application to a seller who charges all customers the same price, even though that price is so low that the seller will suffer out-of-pocket losses, and even if the result may be to drive out more efficient competition with less staying-power.[116] Such across-the-board low prices may run afoul of other antitrust laws, particularly Section 2 of the Sherman Act, which prohibits monopolization, attempts to monopolize, and conspiracies to monopolize.[117]

Monopolization, however, is found only if the defendant already possesses monopoly power, together with the intent and purpose to exercise it.[118] A finding of attempt to monopolize requires a "dangerous probability" of success, as well as proof of overt acts committed with the specific intent to destroy competition or to achieve monopoly power.[119] Predatory price cuts

115 *See* text accompanying note 222 *infra.*

116 *See* text accompanying note 12 *supra.*

117 15 U.S.C. § 2 (1970).

118 United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966); United States v. E.I. Du Pont DeNemours & Co., 351 U.S. 377, 389-94 (1956); Cal Distributing Co. v. Bay Distributors, Inc., 337 F. Supp. 1154, 1157 (M.D. Fla. 1971); Keco Industries, Inc. v. Borg-Warner Corp., 334 F. Supp. 1240, 1245 (M.D. Pa. 1971).

119 Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 626 (1953); Lorain Journal Co. v. United States, 342 U.S. 143, 153 (1951); George R. Whitten, Jr. Inc. v. Paddock Pool Builders, Inc., 508 F.2d 547, 550 and n.2 (1st Cir. 1974); Bernard Food Industries, Inc. v. Dietene Co., 415 F.2d 1279, 1284 (7th Cir. 1969), *cert. denied,* 397 U.S. 912 (1970); H.F. & S. Co., Inc. v. American Standard, Inc.,

do not constitute a violation of this section, therefore, until the predator has acquired a sufficiently large share of the market to make monopoly either an accomplished fact[120] or a dangerous probability;[121] by this time substantial injury to competition has already occurred. The requirement of intent, furthermore, may be difficult to prove in cases of low but uniform pricing.

Section 3 of the RPA prohibits the sale of goods "at unreasonably low prices for the purpose of destroying competition or eliminating a competitor."[122] It can be enforced only by the Justice Department, however, because it provides only criminal sanctions. The lack of provision for private actions, as well as the failure to specify what is meant by "unreasonably low prices" constitute serious weaknesses in the section. It is rarely used.[123]

Despite the fact that uniform-but-low pricing conduct is seldom penalized under existing law, there are a number of situations in which such conduct may have adverse economic effects. Pricing conduct having such effects is often referred to pejoratively as "predatory pricing."[124] In order to determine the circumstances in which non-discriminatory pricing practices are economically desirable (and therefore unworthy of the term "predatory"), we shall consider a number of competitive situations.

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336 F. Supp. 110, 124 (D. Kan. 1972); Huron Valley Publishing Co. v. Booth Newspapers, Inc., 336 F. Supp. 659, 662 (E.D. Mich. 1972) (injunction denied); Cal Distributing Co. v. Bay Distributors, Inc., 337 F. Supp. 1154, 1157 (M.D. Fla. 1971); Keco Industries, Inc. v. Borg-Warner Corp., 334 F. Supp. 1240, 1245 (M.D. Pa. 1971). *But see* Hallmark Industry v. Reynolds Metals Co., 489 F.2d 8, 12 and n.3 (9th Cir. 1973) (dangerous probability or substantial market power need not be established where specific intent to set prices or exclude competition without legitimate business purpose existed).

120 United States v. Grinnell Corp., 384 U.S. 563 (1966) (87% market share was held to be a monopoly); American Tobacco Co. v. United States, 328 U.S. 781, 797 (1946) ("over two thirds of the entire domestic field of cigarettes, and . . . over 80% of the field of comparable cigarettes" constituted a monopoly); United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945) (90% share was sufficient; court had indicated that 60% or 64% might not be sufficient, and 33% "certainly" not). *Id.* at 424. *But see* Stran Auto Sales Corp. v. World Wide Automobile Corp., 166 F. Supp. 313, 314 (S.D.N.Y. 1958) (56% share in 1955 that declined to 31% in 1957 sufficient to constitute a claim of action).

121 To establish dangerous probability, plaintiff must show that the probable market power of defendant after commission of the alleged unlawful acts would have been sufficient to constitute the power to monopolize. H.F. & S. Co., Inc. v. American Standard, Inc., 336 F. Supp. 110, 124 (D. Kan. 1972).

122 15 U.S.C. § 13a (1970).

123 *See* note 12 *supra*.

124 *See* Areeda and Turner, *supra* note 46, at 697, 701-16 (1975).

This discussion of non-discriminatory pricing takes as its starting point the conclusions reached by Areeda and Turner[125] regarding the circumstances in which non-discriminatory pricing policy should be forbidden as "predatory." They conclude that any firm should be permitted to set prices at or above marginal cost.[126] They further conclude that a firm possessing monopoly power should not be permitted to price below marginal cost, except in the unlikely case where the price, though lower than marginal cost, exceeds average cost.[127] Lastly, they conclude that the monopolist should not be permitted to justify below-marginal-cost pricing either on the grounds that it is "promotional" or on the grounds that the low price was charged in order to meet a competitor's price.[128] They reject the "meeting competition" defense not only where it is used to justify matching a competitor's legal price, but also where it is used to justify meeting an illegal one.[129]

Thus we have generally adopted Areeda and Turner's analysis with respect to pricing policy where no price-discrimination is involved. We will not formally rederive their conclusions. However, the major provisions of our proposal regarding the non-discriminatory case will be set forth, and some of the economic justifications for these provisions will be detailed.

In the following analysis, we shall assume a market of three or more firms, but we shall direct our attention to two particular firms. One of these firms, an established competitor, possesses a substantial market share and a fair amount of monopoly power. We shall designate this competitor, Established Firm. The other firm, which has just entered the market and has so far obtained

125 *Id.*

126 *Id.* at 709-12. Because of the difficulties of calculating marginal cost, they recommend that average variable cost be used as a surrogate for marginal cost. *Id.* at 716-718. Our proposed act conforms with this recommendation; *see* model statute § 16 *infra.*

127 *Id.* at 712-13. Areeda and Turner explain that below-marginal-cost but above-average-cost pricing is "unlikely . . . [to continue] for any substantial length of time, because the prospects of recovering profits lost through attempted predation would be dim." *Id.* at 713. Because such pricing, although rare, might have some deterrent effect on new entry, however, we have declined to follow Areeda and Turner's suggestion that below-marginal-cost but above-average-cost pricing be allowed.

128 *Id.* at 713.

129 *Id.* at 715.

only a negligible market share, is designated as New Entrant.[130] Both Established Firm and New Entrant operate in only the one market under consideration, and both operate a single plant.

We shall examine first the situation in which New Entrant is a more efficient producer than Established Firm, then where the two are equally efficient, and finally where New Entrant is less efficient.

1. New Entrant a More Efficient Producer than Established Firm

Assume that New Entrant is more efficient than Established Firm at every relevant range of output; that is, at any level of output, New Entrant's marginal costs of production are lower than those of Established Firm. This may result from a number of factors, such as New Entrant's possession of a superior technological process which is, perhaps, protected by a patent.

Assume that because of New Entrant's lower costs, he sets a lower price on his product than that charged by Established Firm. Assume for the moment that New Entrant's price, although lower than Established Firm's price, is not below the latter's marginal costs. This is theoretically possible, since Established Firm, because of his monopoly power, has presumably set his price above his marginal costs.[131] New Entrant can thus "skim off" a portion of Established Firm's monopoly profits by pricing between Established Firm's price and the latter's marginal costs.

Assume that Established Firm, in order to protect his market share, then responds by matching New Entrant's price throughout the market. By our assumptions, Established Firm and New Entrant are both pricing above their respective marginal costs. Is there anything economically objectionable in allowing them to do so? We conclude that there is not, and our model statute would allow such conduct.[132]

A detailed anaysis of the reasons for permitting any non-price-discriminating producer to follow any across-the-board pricing

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130 "New Entrant" can be conceived of as any small firm in the relevant market and does not necessarily have to be a new entrant.

131 *See* note 37 *supra*.

132 *See* model statute § 3 *infra*.

policy as long as he prices at or above marginal cost[133] has been done by Areeda and Turner.[134] We shall not retrace their reasoning here, but shall describe in an intuitive manner the arguments for allowing at-or-above-marginal-cost-pricing.

First, Established Firm by at-or-above-marginal-cost pricing will almost never destroy a more efficient or equally efficient rival. All such equally or more efficient competitors will by hypothesis be able to cover their marginal cost while charging the same price as Established Firm, and they will almost always be able to stay in business on that basis.[135] The only competitors who will be injured by Established Firm's at-or-above-marginal-cost pricing are those which are less efficient. Such less efficient firms might be forced to price below their marginal costs in order to meet Established Firm's price, and they will probably be eliminated from the market.

But the elimination of such less-efficient firms is not undesirable. The goal of the economic system must, of course, be to encourage productive efficiency, and this goal is not disserved by permitting Established Firm to price above or at its marginal cost.

In fact, if Established Firm were not permitted to price at marginal cost, the result would be a waste of resources. The less efficient firms which would be permitted to survive in the "umbrella" between Established Firm's marginal costs and the higher price which it would be forced by a prohibition on marginal cost pricing to charge, would be drawing productive resources away from other, more efficient uses.[136]

Finally, any prohibition of marginal cost pricing would involve tremendous administrative difficulties. If Established Firm

133 This assumes that he does not practice price-discrimination. The existence of price-discrimination raises further problems, which are treated in text accompanying note 171 *infra*.

134 *See* Areeda and Turner, note 124 *supra,* at 709-712.

135 A small firm, such as New Entrant, might have had start-up costs which were so great that even at an above-marginal-cost price matched by Established Firm, New Entrant might be unable to pay off its initial investment. *See* Areeda and Turner, note 124 *supra* at 710, for an illustration of this situation. Nonetheless, this will happen sufficiently rarely, and the problems of preventing it, as pointed out in the text which follows, are sufficiently great, that this possibility must be disregarded.

136 *See generally* F. SCHERER, *supra* note 20, at 216-19.

is not permitted to price at its marginal cost, then a higher floor on its permissible pricing would have to be set. Although one higher floor which might be set would be its profit-maximizing price, that price is even more difficult for Established Firm to calculate than marginal cost (or the surrogate for marginal cost proposed by our revision, average direct operating expenses).[137] Also, it would be rather absurd to legally support oligopoly pricing. In short, no price floor other than marginal cost makes either economic or administrative sense.

Therefore, we conclude that Established Firm must be allowed to pursue any at-or-above-marginal-cost pricing scheme which it desires, provided that it does not price-discriminate. We would even permit it to pursue a "disciplinary pricing" strategy, or in other words, price reductions to punish competitors for undercutting Established Firm's price.[138] Such disciplinary pricing will not eliminate more or equally efficient competitors, and it will by its very nature reduce the monopoly profits obtained by Established Firm.[139]

We turn now to the more difficult case of below-marginal-cost pricing. Suppose that New Entrant, instead of charging a price above Established Firm's marginal cost, prices below the latter's marginal cost but above its own. For the reasons set forth above, New Entrant's conduct is permissible, since only less efficient rivals (such as Established Firm) will be damaged. But may Established Firm respond by lowering its own price to meet, or beat, that of New Entrant?

It is clear that Established Firm could not pursue such a below-marginal-cost strategy indefinitely. If it did so, it would by definition be taking an out-of-pocket loss on each unit sold, and it would be better off ceasing production. Established Firm may, however, reason that if it can price below its marginal cost, and below New Entrant, for a while, it will be able to recapture many of New Entrant's customers, eliminate New Entrant from the market, and then be able to raise its prices back to a profitable

137 *See* comment to model statute § 16 *infra*.

138 *See generally* F. SCHERER, *supra* note 20, at 213-38.

139 For a fuller analysis of the reasons for permitting even a monopolist to engage in at-or-above-marginal-cost disciplinary pricing, *see* Areeda and Turner, *supra* note 124 at 712, n.35.

level. If the barriers to entry into the market are high, this strategy would be profitable overall for Established Firm, since once New Entrant is eliminated it would be able to recoup in monopoly profits what it lost in the below-marginal-cost pricing scheme.[140]

The economic disadvantages of allowing Established Firm to price below its marginal costs are substantial. Since by hypothesis, New Entrant is a more efficient competitor than Established Firm, the efficiency of the market will suffer if New Entrant is eliminated. Prices will be higher than if it had remained, and the benefits of New Entrant's technological superiority will be lost to consumers. Although under existing law Established Firm would not have any Robinson-Patman liability as long as its price cut was uniform, and even a violation of Section 2 of the Sherman Act would be difficult to establish,[141] the disadvantages

140 The term "barriers to entry" refers to the initial investment which a firm must make in order to be able to compete in a particular market. Typically these start-up costs will include a substantial investment in physical plant, advertising, and perhaps salarial or rental commitments as well. Where these start-up costs are so great that firms do not often enter the market, the market is characterized as having high barriers to entry. *See generally* J. BAIN, BARRIERS TO NEW COMPETITION, (1959). It is only rarely that the scheme outlined here would in fact be successful for Established Firm. The biggest danger for him is that New Entrant will dispose of his technological weapon to another competitor, or another new entrant, who will then pose the same low-pricing problem to Established Firm.

Areeda and Turner indicate that below-marginal-cost predatory schemes such as that outlined for Established Firm, are only rarely attempted, and only infrequently successful:

> Although a predator may drive competitors into bankruptcy, their durable assets may remain in the market in the hands of others. Moreover, a firm can anticipate monopoly profits for only so long as its monopoly prices do not attract new entry. Losses incurred through predation could be regained in markets with very high barriers to entry. In many markets, however, and especially in those having a number of small rivals, entry barriers may be nonexistent or at least too low to preclude entry. Admittedly, a demonstrated willingness to indulge in predatory pricing might itself deter some smaller potential entrants, but it is unlikely to inhibit firms with resources comparable to those of the predator. Repeated predation in the same market, moreover, is not only costly but is likely to be easily detectable and thus the occasion for severe antitrust sanctions. The prospects of an adequate future payoff, therefore, will seldom be sufficient to motivate predation. Indeed, proven cases of predatory pricing have been extremely rare.

Areeda and Turner, *supra* note 124, at 698-99. For support of the proposition that predatory pricing schemes are rare, *see* Koller, *The Myth of Predatory Pricing—An Empirical Study*, 4 ANTITRUST L. & ECON. REV. 105 (Summer 1971).

141 *See* text accompanying notes 117-20 *supra*.

of New Entrant's elimination from the market are for the above reasons sufficiently great that Established Firm's below-marginal-cost-and-below-New Entrant's-price scheme should not be permitted. The proposed Act accomplishes such a result, by prohibiting below-marginal-cost pricing, even in the absence of price discrimination, unless the seller is a small competitor.[142]

Established Firm may decide that rather than charging a price lower than New Entrant's, it will merely meet New Entrant's price. The economic disadvantages of allowing Established Firm to do so are less obvious than where it wishes to underprice New Entrant, but these disadvantages are nonetheless substantial. Although the effect on New Entrant may not be too drastic,[143] the chilling effects on *potential competition* are likely to be substantial.[144] Furthermore, to allow Established Firm to meet New Entrant's price, when we have already concluded that it should not be allowed to undercut that price, may lead to administrative difficulties in determining whether the price was merely met, or beaten. As Areeda and Turner point out, "Courts would have to undertake the difficult task of assessing differences in product quality and thus become involved in speculation about consumer preferences."[145]

A third reason for disallowing the meeting-competition defense to a below-marginal-cost pricer such as Established Firm, is that

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142 *See* model statute §§ 3-6 *infra.*

143 If Established Firm is allowed to price below marginal cost in order to meet New Entrant's price, New Entrant will not achieve as large a percentage of the market as if Established Firm were not allowed to do so. New Entrant will therefore make lower profits. But in all probability New Entrant will still be able to function at a profit, and Established Firm will of course not be able to keep up his below-marginal-cost pricing indefinitely.

144 To see the chilling effect on potential competition of allowing Established Firm the right to match a price by New Entrant which is lower than Established Firm's marginal costs, suppose that a third firm, Potential Entrant, is considering whether to come into the market. Potential Entrant is reasonably confident that it can match New Entrant's technology, and thus compete on equal footing with it. But if Established Firm is allowed to match New Entrant's price, then Potential Entrant's initial share of the market, and its initial revenues, will be lower than if Established Firm is not allowed to pursue his below-marginal-cost scheme. The existence of Established Firm's low price may be just enough to dissuade Prospective Entrant from entering the market. If so, the dissemination of the new technology, and an increase in competition, will have been prevented.

145 Areeda and Turner, *supra* note 124, at 716. For a discussion of judicial difficulties in determining whether the defendant has merely met, or in fact beaten, a rival's price, *see* F. ROWE, *supra* note 95, at 240-47.

the administrative need for the meeting-competition defense is obviated by our proposed revision. The meeting-competition defense was incorporated into the current Act in order to mitigate the Act's expected detrimental effects on competition, particularly its tendency to promote price inflexibility.[146] The proposed revision allows low pricing (and in some cases even price discrimination)[147] as long as the price stays at or above marginal cost. This allowance reduces the danger of price inflexibility, and the need for the meeting-competition defense is correspondingly reduced.

For these reasons, we conclude that an established producer with a substantial share of the market should not be allowed to meet the above-marginal-cost price of a competitor by charging a below-marginal-cost price. This conclusion is at odds with the Justice Department proposal,[148] which provides that a seller who does not price-discriminate may always meet the low price of a competitor, even if the seller must price below marginal-cost to do so.

Even assuming that Established Firm ought not be allowed to assert the meeting-competition defense where New Entrant's price is above marginal cost, the question remains whether Established Firm should be allowed to assert the defense if New Entrant's price is below marginal cost and therefore unlawful under Section 3 of our proposed model statute.[149] In other words, should Established Firm have the right to meet an unlawfully-charged price which is below Established Firm's marginal cost, once we have concluded that it should not have the right to meet a lawfully-charged price below its own marginal cost?

Areeda and Turner suggest that although the case for allowing the meeting-competition defense to justify a below-marginal-cost price which meets a competitor's price is stronger if the competi-

146 *See* F. ROWE, *supra* note 95, at 208-10.

147 The proposed revision allows above-marginal-cost price discrimination as long as no secondary-line injury occurs. *See* model statute § 5 *infra*.

148 Justice Report, *supra* note 5, at 18.

149 The desirability of allowing New Entrant to initiate below-marginal-cost pricing will be considered subsequently in the treatment of promotional pricing. *See* text accompanying note 212 *infra*.

tor's price is unlawful than if it is lawful,[150] the meeting-competition defense should nonetheless not be permitted, even in the stronger case. Their reasoning, in which we concur, has a pragmatic basis. If the defense is allowed where the price to be met is unlawful, but not where the price to be met is lawful, the courts will be obliged to make a frequently difficult determination of legality. Since the party charging the price whose legality is in question will not always be before the court,[151] the task will be rendered still more difficult due to a lack of data. On balance, therefore, we conclude that the advantages of allowing a firm to price below marginal cost in order to meet a rival's unlawful price are outweighed by the disadvantages, at least where the firm asserting the meeting-competition defense is an established competitor with a substantial share of the market.[152]

Our denial of the meeting-competition defense to an established

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150 Areeda and Turner explain this stronger case as follows:

> There is some basis for allowing a monopolist to meet a rival's unlawful price. The rival's unlawful price is not competition on the merits, and there is no strong reason for denying even a monopolist the opportunity to defend himself from predatory attack. Retaliation may possibly increase the waste of productive resources in the short run, but it is likely to serve the useful purpose of bringing the predator's unlawful pricing to a quicker end.

Areeda and Turner, *supra* note 124, at 716.

151 In the two-firm case under discussion here, the party whose price is to be met, New Entrant, will of course be before the court. But in the more common case, Firm A will respond to a low price charged by Firm B, and will be sued by Firm C, who is either a competitor of A and B or a customer of A who does not get the benefit of the low price. In such a situation, Firm B might not be a party to the action, and it will be difficult to determine whether his low price was lawful, particularly since under our proposed revision its legality will depend on his particular cost structure. *See* model statute §§ 3, 4 *infra.*

152 Where the seller seeking to meet a rival's unlawful price is a small competitor, we would allow the meeting-competition defense, whether or not the small seller believes that the price he is meeting was lawfully charged, except in certain price-discrimination cases involving secondary-line injury, discussed in text accompanying notes 214-16 *infra.* Thus in the non-price-discriminatory case, we allow the meeting-competition defense to a small seller regardless of his own marginal costs, regardless of his price-cutting rival's marginal costs, and regardless of whether the small seller thinks he is meeting a lawful or unlawful price. The chief reason for making such an allowance is the necessity for permitting the small competitor to defend himself against price-cutting conduct which might drive him out of business if he were required to wait until he could obtain legal relief. Given that our goal is to protect the small but efficient competitor, the reasons for letting him meet an unlawful price are even stronger than for letting him meet a lawful price, which as we stated above we would allow him to do.

firm with a substantial market share, such as Established Firm, does not mean that there are no firms to whom we would permit the meeting-competition defense. Consider the following scenario: after New Entrant has underpriced Established Firm, Established Firm responds by cutting his price below marginal cost. If Established Firm's retaliatory price cut is nonetheless above New Entrant's marginal cost, we would of course allow New Entrant to meet that price, since any non-discriminatory at-or-above-marginal-cost pricing is justified.[153] But if Established Firm's price cut is below New Entrant's marginal cost, should New Entrant nonetheless be permitted to match that price, by the meeting-competition defense?

The administrative and efficiency arguments raised above for denying the meeting-competition defense to an established producer such as Established Firm are to a certain extent present with respect to New Entrant's assertion of the defense. There are, however, several strong countervailing arguments for granting the defense to New Entrant.

First, permitting New Entrant to respond to Established Firm's unlawful price-cut would lessen the probability that Established Firm would attempt the price cut in the first place. If Established Firm cuts its price to below marginal cost, it will of course have to be prepared to suffer out-of-pocket losses. It might be willing to do so if it thought that it could drive New Entrant out of business. But if it knows that New Entrant, whose marginal costs are lower, could respond with a matching price cut of its own, and suffer less of a loss in doing so than Established Firm, Established Firm may be convinced that the entire endeavor is not worthwhile. Thus allowing New Entrant to "answer fire with fire" might dissuade Established Firm from pursuing its unlawful course entirely.

Of course, this dissuasion argument would apply whether New Entrant was a small competitor or not; in fact, it might have more force if New Entrant was large enough to have staying-power equal to that of Established Firm. However, there are two respects in which it is more desirable to allow the small competitor the meeting-competition defense than to allow it to large competitors.

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153 *See* text accompanying notes 133-39 *supra*.

First, a small competitor like New Entrant is more in need of the right to meet competition than is a large competitor, since he typically has less capital reserves, and thus less staying-power. Where most larger competitors will be able to survive long enough to bring an injunction and damage suit under this proposed act against the seller who is unlawfully pricing below marginal cost, the same may not be true of the smaller competitor.

Second, the economic misallocation which would stem from allowing the small competitor to meet competition with a below-marginal-cost price is less severe than that which would occur were a large competitor permitted to do so; the small competitor has by definition fewer productive resources, so that the skewing of society's total resources which would result is less severe.

For these reasons, we conclude that a small competitor should be permitted to assert the meeting-competition defense to meet a rival's unlawful price, even if to do so the small competitor must price below marginal cost. For administrative reasons, it is desirable to also let it meet a lawful price, if it has the right to meet an unlawful one. Otherwise, a court might have to determine the legality of a price charged by a party not before the court.[154]

The above discussion of the reasons for permitting a small competitor such as New Entrant to meet a rival's price assumes that the small competitor is more efficient than its rival. When we consider the case in which New Entrant is equally efficient, or less efficient than Established Firm, we shall come to the same conclusion and shall allow it the meeting-competition defense.[155]

It is important to note that all of the above analysis concerning when the meeting-competition defense should be allowed relate to the seller who is not practicing any price discrimination, that is, whose prices, while low, are uniform in a given market. The analysis of the situation in which price discrimination exists, particularly that where secondary line injury occurs, will reach a different conclusion with respect to when the meeting-competition defense should or should not be permitted.

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154 Similar considerations led us to conclude that if the large competitor should not have the right to meet a lawfully-charged price, he should not be permitted to meet an unlawful one either. *See* text accompanying notes 150-52 *supra.*

155 *See* text accompanying notes 149-53 *supra,* and notes 168-69 *infra.*

The analysis thus far has assumed that Established Firm is an oligopolist. If we change our assumption so that Established Firm does not possess a sufficiently great market share to give it monopoly power, our conclusions about the desirability of allowing it to price below marginal cost remain the same. The disadvantages of allowing Established Firm to drive out the more efficient New Entrant through below-marginal-cost pricing are not lessened by the lack of Established Firm's status as an oligopolist — the market will still be losing a more efficient competitor if New Entrant is eliminated. It is considerably less likely that Established Firm will be able to afford the below-marginal-cost strategy in the first place, since it must compete with other firms as well as with New Entrant, and since it may not have the necessary staying-power on account of its relatively smaller size. Nonetheless, the fact that the below-marginal-cost pricing scheme is less likely to occur where Established Firm is not oligopolistic is no reason for allowing it when it does occur. Therefore, the proposed revision forbids below-marginal-cost pricing regardless of the structural features of the seller's market.

This rule, like the rule on meeting competition,[156] is at odds with the Justice Department proposal.[157] That proposal would allow a firm with a market share of less than ten percent to price below marginal cost in all cases. In our opinion, this provision may allow a small firm to severely damage a still smaller one by below-marginal-cost pricing,[158] and is not justified in the usual case.

2. New Entrant and Established Firm Equally Efficient

If we change our assumptions so that New Entrant is not more efficient than Established Firm, but merely equally efficient, our

156 *See* text accompanying notes 140-55 *supra.*

157 Justice Report, *supra* note 5, at 51.

158 Suppose Established Firm has nine percent of the market, and New Entrant has five percent. The Justice Department would allow Established Firm to make across-the-board below-marginal cost price cuts even where no meeting-competition rationale were present. This might be, so to speak, the "straw that breaks New Entrant's back." Because we see no valid economic purpose for allowing such price cuts, except for short-run promotional purposes, *see* text accompanying note 64 *infra,* we would not allow them. We would, however, allow Established Firm to make the below-marginal-cost price cuts if they were in response to a low price offered by a third competitor. *See* text above note 58 *supra.*

conclusions about the pricing practices which ought to be prohibited to New Entrant and to Established Firm remain unchanged.

We shall not repeat the reasoning used in the case where New Entrant was more efficient than Established Firm.[159] The prohibitions developed in that analysis will perform the same function where New Entrant is equally as efficient as where it is more efficient than Established Firm — that is, these prohibitions will prevent Established Firm from driving New Entrant out of business. This is a desirable goal, since apart from the fact that New Entrant is equally efficient and should therefore have the right to do business, its presence in the market may help keep Established Firm's oligopolistic profits at a lower level.

a. Promotional Pricing — If New Entrant's efficiency is merely equal to, not superior to, that of Established Firm, a problem involving promotion pricing is likely to arise that was not confronted in the analysis above. New Entrant, since it has not gained an appreciable market share, may well elect to sell its product at a price lower than that charged by its competitors, including Established Firm. If New Entrant were more efficient than these other competitors, it would not need to price below its marginal costs; nor would it need to do so if it were equally efficient and the existing firms were oligopolists pricing above marginal costs. But if the market is fairly competitive, and New Entrant is no more efficient than the existing producers, it will be able to undersell them only by pricing below marginal cost. Should it be allowed to do so?

We conclude that such below-marginal-cost promotional pricing on the part of a new entrant is desirable, and should be encouraged. Because of brand loyalty enjoyed by the products of the established producers, or simply because of the inertia of consumers, New Entrant may be unable to acquire a viable market share if he merely meets the prices of existing producers. Because the entrance of new, equally efficient competitors into the market is generally desirable, we would therefore permit such below-marginal-cost promotional pricing, despite the fact that it will have a short-term tendency to divert consumers from better products

159 *See* text accompanying notes 140-55 *supra.*

or more efficient producers. However, ". . . the diversion will last only long enough for consumers to judge and reject the inferior, promoted product."[160]

Should below-marginal-cost promotional pricing be permitted to a small firm which has been in the market for some time already? We conclude that it should, again for a moderate period of time. As in the case of a new entrant, it is desirable to encourage the stability and growth of small producers. Particularly in industries where consumer choices are made largely by reference to brand-name familiarity, the established but little known, competitor faces the same problems as the new entrant. Therefore, he should be allowed to promote his product by pricing below marginal cost for a reasonable time period.[161]

It is important to point out that the model statute,[162] like the present Act[163] and the Justice Department proposal,[164] forbids only pricing tactics which are of longer-than-temporary duration. Our proposed revision would, in addition to permitting truly temporary pricing practices of any sort, allow small or new entrants to pursue somewhat longer-range promotional pricing practices.[165] We have adopted the Justice Department view that short-term pricing practices, on which no limits at all are placed, should be limited to 60 days duration.[166] The length of time for which small and new entrants may pursue promotional pricing schemes shall be limited to six months.[167]

Suppose that New Entrant undertakes, as we would permit, a below-marginal-cost promotional campaign. As concluded above, Established Firm should not be permitted to meet New Entrant's

160 *See* Areeda and Turner, *supra* note 124, at 714.

161 *See id.* at 714-15.

162 *See* model statute § 3 *infra.*

163 Viviano Macaroni Co. v. FTC, 411 F.2d 255, 259 (3d Cir. 1969) (participation for three years on annually renewable contract was additional evidence that manufacturer did not participate "to stave off competition," but rather to accommodate a large customer).

164 Section 3 of the Justice Department proposal refers to sales "on a sustained basis." Justice Report, *supra* note 5, RPA Reform Statute § 3. "[T]o sell on a sustained basis" means "to sell the commodity in question for more than 60 days within a period of one year." *Id.* § 13(f).

165 Model statute § 4(b) *infra.*

166 *Id.* § 17(1).

167 *See* model statute § 7 *infra.*

promotional price, where this would require Established Firm to price below marginal cost. To allow him to do so would be to drastically reduce the effectiveness of the promotional pricing technique for new entrants and small competitors. Is this a pressing, critical, or vital need? The very rationale for permitting them to engage in promotional pricing is to encourage them to make their product better known; this rationale does not apply to Established Firm, whose "promotion would not usually intensify competition but would only decrease it."[168] Established Firm should not be granted the privilege of below-marginal-cost pricing merely because New Entrant desires to engage in promotional pricing. Established Firm could, of course, lower his price down to his marginal cost, in conformity with the general principle of our model statute to permit all non-discriminatory pricing that is not below marginal cost.

b. Meeting-Competition Defense—We have already concluded that where New Entrant is more efficient than Established Firm, there are sound economic reasons for permitting him to assert the meeting-competition defense, thus allowing him to match any price set by Established Firm, whether or not below New Entrant's marginal cost.[169] Equally strong reasons require that New Entrant be allowed to meet a price charged by a rival of equal efficiency. If a small competitor such as New Entrant is not permitted to protect itself in this way, it may be eliminated from the market before it has a chance to bring an action for injunction or damages under the model statute.

We would, in fact, permit the meeting competition defense to be asserted by New Entrant even if it were *less* efficient than the rival whose price it proposed to meet, and even if the rival's price is above the rival's marginal cost. The administrative simplicity of always giving the small competitor the meeting competition defense is obvious. Further, the damage to the efficiency of the system, and to other small firms, is sufficiently small where a small producer meets another producer's price, that we would always permit him to do so.

168 Areeda and Turner, *supra* note 124, at 714.
169 *See* text accompanying notes 153 and 154 *supra*.

3. New Entrant Less Efficient than Established Firm

The case in which New Entrant is less efficient than Established Firm leads to the same conclusions as the cases in which New Entrant is more or equally efficient.

It is true, of course, that in this situation Established Firm may eliminate New Entrant by pricing below New Entrant's marginal cost, but still above its own marginal cost. For reasons given above,[170] however, this result is one worth tolerating for the sake of price flexibility and economic efficiency.

In conclusion, we would govern New Entrant by the same rules whether it is more, equally, or less efficient than its competitors. That is, we would permit it to price at or above marginal cost in all situations, and below marginal cost only when it is meeting the price of a competitor or engaging in promotional pricing. Similarly, we would require existing firms to behave towards New Entrant the same way regardless of New Entrant's relative efficiency — that is, existing firms could always price above marginal cost, and could not price below marginal cost unless they are small producers matching some other producer's low price.

B. *Price Discrimination where only Primary Line Injury is Involved*

The previous section has examined economic reasons for permitting or prohibiting various kinds of non-discriminatory pricing policy. That is, implicit in the above analysis has been the assumption that each producer charges all of his customers the same price. We turn now to the situation in which not all customers of a particular seller are charged the same price, but in which all customers competing *within a given market* do receive the same price. In such a situation, only primary-line injury,[171] not secondary-line injury,[172] can occur.[173]

The most obvious case in which price discrimination can be

170 *See* Section III(A) *supra.*

171 *See* text accompanying note 33 *supra.*

172 *See* text accompanying note 34 *supra.*

173 Third and fourth line injury may possibly occur where customers of the seller's customers compete. This permutation, however, is fairly remote.

practiced without secondary-line effects is that involving two separate geographic markets. Suppose that Established Firm serves two markets, the New York market and the San Francisco market. Suppose also that New Entrant has previously competed only in the former, but now seeks to compete in San Francisco as well. Further assume that neither firm price discriminates within a given market and that no customers in the New York market compete with customers in the San Francisco market. On these facts, it can be seen that even if New Entrant or Established Firm charges one price in New York, and a different one in San Francisco, no customer's ability to compete can be truly injured by this differential, since no customer must pay a higher price than a competitor. There is therefore no secondary line injury, although primary line injury is possible.

However, price discrimination which results in primary-line injury is prohibited by Section 2(a) of the RPA.[174] Concern about primary line injury traces back to Section 2 of the original Clayton Act.[175] Section 2 was enacted in 1914 in response to the fear that the large trusts (especially the tobacco and oil industries) would use their monopoly power in one market to subsidize predatory pricing to destroy competition in another.[176] Although the 1936 Robinson-Patman amendment of Section 2 was more concerned with the effect of price discrimination on competition between the favored buyer and his competitors (i.e., secondary line injury),[177] the old Clayton Act primary line provisions were carried forward in the amended version.

The key question, of course, is what constitutes injury to competition at the primary line. The new provision supplied by the Robinson-Patman amendment prohibits price discrimination

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174 *See* text accompanying note 13 *supra.*

175 Act of Oct. 15, 1914, ch. 323, § 1, 38 Stat. 730 (1914).

176 The House Judiciary Committee described its purpose as follows:

> Section 2 of the bill is intended to prevent unfair discriminations. It is expressly designed with the view of correcting and forbidding a common and widespread unfair trade practice whereby certain great corporations . . . have heretofore endeavored to destroy competition and render unprofitable the business of competitors by selling their goods . . . at a less price in the particular communities where their rivals are engaged in business than at other places throughout the country.

H.R. REP. No. 627, 63d Cong., 2d Sess. 8 (1914).

177 *See* note 1 *supra.*

which might "injure, destroy, or prevent competition with any person who . . . grants . . . the benefit of such a discrimination."[178] A literal reading of this seems to imply that any discrimination causing injury to a single competitor might satisfy the statutory test. This is the basis of the "diversion of business" test, which fortunately has been discredited by the later decisions.[179]

While it is generally agreed that broader injury to competition must be demonstrated, the definitive lines have not been clearly drawn. Courts have relied on numerous factors such as predatory intent,[180] sales below cost,[181] or the seller's independent source of strength[182] to support findings of competitive injury. The Supreme Court's holding in *Utah Pie Co. v. Continental Baking Co.* has served only to augment the confusion.[183] There the Court relied on the presence of below-cost pricing (seemingly average total cost), predatory intent, and a "deteriorating price structure" to find that a prima facie case of price discrimination had been made.[184] This was despite the fact that the plaintiff, Utah Pie,

178 15 U.S.C. § 13(a) (1970).

179 *See* Minneapolis-Honeywell Regulator Co. v. FTC, 191 F.2d 786 (7th Cir. 1951), *cert. denied,* 344 U.S. 206 (1952); Anheuser-Busch, Inc. v. FTC, 289 F.2d 835, 840 (7th Cir. 1961).

180 *See, e.g.,* FTC v. Anheuser-Busch, Inc., 363 U.S. 536, 548, 552 (1960); Moore v. Mead's Fine Bread Co., 348 U.S. 115, 118 (1954); Forster Mfg. Co. v. FTC, 335 F.2d 47, 53 (1st Cir. 1964), *cert. denied,* 380 U.S. 906 (1965); Atlas Building Prod. Co. v. Diamond Block & Gravel Co., 269 F.2d 950, 956-957 (10th Cir. 1959), *cert. denied,* 363 U.S. 843 (1960); Maryland Baking Co. v. FTC, 243 F.2d 716, 718 (4th Cir. 1957); E.B. Muller & Co. v. FTC, 142 F.2d 511, 517 (6th Cir. 1944).

181 *See, e.g.,* FTC v. Anheuser-Busch, Inc., 363 U.S. 536, 552 (1960); Utah Pie Co. v. Continental Baking Co., 386 U.S., 698-99, 701-02 (1967); United States v. National Dairy Products Corp., 372 U.S. 29, 31, 33-35 (1963). Unfortunately, judicial analysis has not focused on the question whether below "seller's" cost refers to average total cost or marginal cost. *See, e.g.,* National Dairy Products Corp., *id.* at 34-35. This is the key economic issue, since firms should be permitted to meet competitive pressures by pricing below average total cost, so long as marginal costs are recovered. Such pricing is not "predatory," since no out-of-pocket losses are sustained. *See* note 37 *supra* and text accompanying note 135 *supra*; *see generally* C.E. FERGUSON, MICROECONOMIC THEORY 210-21, 257-64 (3d ed. 1972).

182 The independent strength of the price discriminator is often regarded as important, where, for example, a large nationwide seller confronts a small regional competitor. *See, e.g.,* Atlas Products Co. v. Diamond Block & Gravel Co., 269 F.2d 950, 956 (10th Cir. 1959), *cert. denied,* 363 U.S. 843 (1960).

On this topic, *see generally* Note, *Unlawful Primary Line Price Discriminations: Predatory Intent and Competitive Injury,* 68 COL. L. REV. 137 (1968).

183 386 U.S. 685 (1967).

184 The Court found that one of the defendants, Continental, had sold at a price "less than its direct cost plus an allocation for overhead" — that is, its average total cost. *Id.* at 698. The Court also pointed out instances of behavior by the defendants

enjoyed increasing sales and sustained profits during the period complained of.[185]

To replace such confusion, we recommend that the legitimacy of pricing practices in cases of price discrimination without secondary-line injury should be measured by precisely the same tests as those set forth above for the case of non-discriminatory predatory pricing.[186] The same tests should be applied in both cases because the potential harm is the same in both — injury to the competitors of the seller from predatory pricing. The fact that the price to buyers in one market is higher than the price to buyers in other markets is irrelevant where the buyers in one market are not competing with buyers in the other markets (i.e., no secondary-line effects). In such a case the price in one market does not affect competition in the other markets. The effects of pricing in the individual markets, viewed separately, is precisely the framework of analysis of predatory-pricing restrictions.

Although the RPA was directed primarily at secondary-line competition,[187] the original Section 2 of the Clayton Act was designed to prevent predatory pricing that was facilitated by price discrimination.[188] This could occur if a seller with a monopoly in one market used his monopoly profits to "finance" or "subsidize" predatory below-cost pricing in another to drive a local rival in that market out of business. Such predatory pricing tactics are objectionable, however, whether or not the price charged in the competitive market is lower than that charged in other markets. In other words, it is not the price discrimination but the predation, regardless of how it is "financed," that is objectionable.

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from which predatory intent could be inferred — *e.g.*, Pet's use of an industrial spy. *Id.* at 697. The presence of a "deteriorating price structure" was noted. *Id.* at 690.

185 "During the entire period involved in these cases, Utah Pie's sales volume and dollar sales substantially increased as did its profits except in 1958, and . . . [its share of the local market] stabilized at about 45 percent the last two years of the period. Throughout such period it was continuously a financially strong business concern and a healthy and effective competitor in the Salt Lake City market." Continental Baking Co. v. Utah Pie Co., 349 F.2d 122, 129 (9th Cir. 1965), *rev'd and remanded,* 386 U.S. 685 (1967). *See also* 386 U.S. 685, 704-06 (1967) (Stewart, J., dissenting).

186 *See* text accompanying notes 116-70 *supra.*

187 *See* note 1 *supra.*

188 *See* note 176 *supra.*

The argument that pricing policies financed by such "subsidization" should be more strictly circumscribed than pricing in the absence of discrimination fails because *any* case of low pricing is subsidized in one fashion or other. Thus a firm with two product lines might "subsidize" its low prices in one line with its more profitable prices in another line. Or a firm with great capital resources might "subsidize" its temporary below-normal profits by dipping into its reserves. There is no reason to single out the particular kind of subsidization resulting from different prices in different markets for the same product, and to subject it to harsher rules than the other kinds of subsidization detailed above.

A second argument for placing more stringent restrictions on the discrimination-without-secondary-line-injury case than on the non-discrimination case is that a national seller may use selective, regional price cuts to drive local sellers out of the market.

For example, suppose Established Firm is competing in both the New York market and in a number of other markets. In many of these markets, Established Firm is an oligopolist, and is therefore able to price above marginal cost. Regional Producer, in an attempt to draw customers away from Established Firm in New York, lowers its price below that charged by Established Firm, although this low price is higher than the marginal costs of either Established Firm or Regional Producer. Should Established Firm be permitted to undersell Regional Producer in New York, as long as it does not price below marginal cost, without being required to drop its prices in all the other markets? The argument under consideration answers this question in the negative. If we are to apply the rule that the discrimination-without-secondary-line injury case is to be treated identically to the non-discrimination case, we must allow Established Firm to make a New York-only price cut (above marginal cost) to undercut Regional Producer's price. But to allow Established Producer to pursue such a policy of "selective retaliation" (i.e, retaliation only against Regional Producer in the New York market) will discourage Regional Producer from making his price cut, since he will fear being undersold. If, on the other hand, we required Established Firm to lower all his prices in all markets or not at all, it might conclude that retaliation against Regional Producer is too expensive, and he would not retaliate. Regional Producer, knowing that Established Firm could not retaliate without lowering his prices everywhere, would go ahead with his own price cut, a desirable result. Thus, so the argument runs, we should not permit Established Producer to lower his price in one market without lowering it everywhere.

The simple response to this argument is that to prevent selective retaliation by Established Producer may serve to maintain "umbrella" pricing. If Regional Producer knows that it doesn't have to worry about Established Firm's retaliation, it may not make it price cut after all, but instead may be content to operate under Established Firm's "price umbrella." Or, if it does drop its price, the price cut might be relatively insubstantial. In other words, if Established Firm is prevented from meeting Regional Producer's low price unless Established Firm is willing to lower his price in all markets, both firms may simply keep prices high, and the goal of promoting low prices from all producers will be thwarted. Hence little can be gained by prohibiting above-marginal cost price discrimination where no secondary-line injury exists.

Thus we would treat a case of price-discrimination without secondary-line effects in the same way as a case of non-discriminatory pricing. This conclusion is shared by Areeda and Turner.[189] In describing the situation in which a lower price is charged in one geographic market than in others, they state that they would "adhere to the general rule permitting pricing at or above reasonably anticipated average variable cost, and permitting any defenses (such as promotional) available to any seller. The deterrent effect of a more severe constraint would, we conclude, be likely to cause more economic harm than good."[190]

The Justice Department proposal would also treat the non-discriminatory and discriminatory-without-secondary-line-injury cases alike. That proposal consists of two major operative sections: (1) a prohibition on pricing below average variable cost;[191]

189 *See* Areeda and Turner, note 124 *supra*, at 726.

190 *Id.* at 725. *See generally* Continental Baking Co. v. Utah Pie Co., 349 F.2d 122, 148, 150 (10th Cir. 1965), *rev'd and remanded*, 386 U.S. 685 (1967).

191 Justice Report, *supra* note 5, RPA Reform Statute § 3. The proposal uses the term "direct operating expense," but the proposal defines the term in such a

and (2) a prohibition on price discrimination which would injure competition with the favored customer.[192] Where the price discrimination does not injure secondary-line competition, the second of these two provisions has no application, and only the first one applies, as it would even if no discrimination existed.

We would therefore allow all discriminatory pricing as long as each price charged by the discriminating seller is at or above marginal cost, and as long as no secondary-line injury occurs. We would prohibit all below-marginal-cost prices, regardless of whether the below-marginal-cost price is lower than other prices charged by the same seller in different markets, with the two following exceptions: (1) We would allow a seller whose share in a particular market is not substantial to meet a competitor's price in that market, even if he charges more in other markets; and (2) We would allow a seller who has not yet obtained a significant market share in a given market to engage in below-marginal-cost promotional pricing in that market, even if he is charging higher prices in other markets.[193]

These two exceptions, which correspond to the two exceptions that we advocate in the non-discriminatory case, will serve to allow a seller to gain a foot-hold in a market in which he does not yet have a significant market share. The exceptions would be open even to the large national seller who does not yet have a significant market share in a market in which he now wishes to compete actively. Thus if the *Utah Pie*[194] situation were to arise under our proposal, the defendants would be acquitted if they either: (1) charged prices in Salt Lake City that were at or above marginal cost;[195] (2) were engaging in below-marginal cost pro-

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way that it means the same thing as the economic term "average variable cost." *Id.* § 13(e).

192 Justice Report, *supra* note 5, RPA Reform Statute § 5. This second test is satisfied in part by a showing either that "the discrimination is part of a pattern which systematically favors larger recipients in the relevant line of commerce over their smaller competitors," *Id.* § 5(a), or that "the discrimination clearly threatens to eliminate from a line of commerce one or more competitors of the recipient where the effect of such elimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce in any section of the country." *Id.* § 5(b).

193 *See* model statute § 4 *infra.*

194 *See* text accompanying note 183 *supra.*

195 Section 3 of model statute *infra.*

motional selling of a duration permitted by the proposed act;[196] or (3) were making a good faith effort to meet the price of a competitor.[197]

Observe that these three exceptions will make entry into a new market significantly less expensive for firms already established in other markets. If below-marginal cost promotional pricing and the charging of below-marginal cost prices to meet competition were required to be uniformly non-discriminatory, the new entrant could pursue these selective pricing policies only by taking the extremely expensive step of reducing his prices by a similar amount in all other, established, markets. This is in fact what present law apparently requires.[198] The proposed revision promotes competition by making such entry considerably less expensive and thus more attractive.

The proposed revision also promotes price competition in still another respect. Under current law, no firm can charge a lower price in one market than in another, even if the lower price is above marginal cost. Under the proposed revision, even a firm which is already established in a particular market can charge a lower price in that market than he charges in other markets, as long as the price within the particular market is uniform.[199]

Thus far, we have discussed the situation in which the price discrimination in question has no secondary line effects at all; we have posited the case of two distinct and unrelated geographical markets as an example of such discrimination without secondary line effects. But what of the case where although no injury to the state of competition[200] on the secondary line occurs, particular customers of the discriminating seller lose business because of the discrimination?

196 *Id.* § 4(b).

197 *Id.* § 4(a).

198 *See generally* Utah Pie Co. v. Continental Baking Co., 349 F.2d 122 (10th Cir. 1965), *rev'd and remanded,* 386 U.S. 685 (1967).

199 *See generally* §§ 3, 5 of model statute *infra.*

200 The "state of competition" in a market is the strength of the economic forces which tend to keep prices in that market no higher than marginal cost. An absolute monopoly is the worst possible state of competition, while perfect competition is the best. *See* White House Task Force Report on Antitrust Policy, BNA 1969 ANTITRUST AND TRADE REG. REP., Special Supp., Part II, 9, 19, comment to § 2(b) (May 27, 1969) [hereinafter cited as Neal Report].

To see how this might occur, consider the following situation. Seller makes a product which is bought by members of a particular industry, which we shall call Industry A. Industry A is composed of a large number of small entrants, and approximates perfect competition. Seller sells to many members of Industry A and they all compete with each other. Out of friendship and a long business relationship, Seller charges one of these customers, Customer 1, a lower price than he charges the rest of them. This lower price enables Customer 1 to produce his product slightly more cheaply, and he sells it at a slightly lower price than all of the other members of Industry A. Because of this lower price, he attracts more customers than he otherwise would, but because of his marketing inefficiency, he does not divert enough customers from any one competitor to cause that competitor to go out of business.

On these facts, it is clear that injury to secondary-line competition as a whole is not threatened. Yet, each particular competitor of Customer 1 could claim that the price discrimination practiced by Seller has cost that competitor a few customers, and some lost profits. Should the existence of this small diversion of business be sufficient to remove Seller from the above tests where there is price discrimination without secondary-line injury?

We conclude that this case is sufficiently close to the case in which no secondary-line effects at all result from price discrimination, that the two situations should be treated in the same manner. Thus the tests described in this section (which are the same as in the completely non-discriminatory situation) apply in all situations in which no severe damage to secondary-line competition as a whole occurs. It is only when the price discrimination has such severe effects on the secondary line that a competitor of a customer of the discriminating seller is in danger of going out of business, or of dropping a product from his line, that the rules set forth in the next section, governing primary-and-secondary-line injury, apply.

This result corresponds to the Justice Department proposal[201] and the White House Task Force recommendations (Neal Report), which mark "a radical departure from existing practice, which at

201 Justice Report, *supra* note 5, at 3.

times has based 'secondary line' violations upon nothing more than substantial price differentials."[202]

C. *Price Discrimination Where Secondary Line Injury Is Present*

All of the pricing conduct which we have examined thus far has had, by hypothesis, effects on the primary line only. We now turn to a somewhat more difficult, and perhaps insoluble, problem: what discriminatory pricing policies with both primary and secondary line effects should be permitted?

This is a difficult problem because it raises two often conflicting goals: the maximization of competition at (1) the primary line and (2) the secondary line. We have shown how the existing Robinson-Patman Act (RPA) has a number of economic disadvantages, but also how the RPA serves several useful functions.[203] The principal reason that the present Act has both good and bad effects is that it stimulates competition at the secondary level, but often at the expense of primary-line competition.

The case of cartel pricing well illustrates the conflict.[204] The purpose of a cartel is to allow its (oligopolist) members to jointly maintain artificially high prices and restrict output as though they were a (single) monopolist. Each member tries to act as if he, and all other members, were under the direct control of a monopolist, who sets the cartel price and output to maximize cartel profits. If one of the cartel members is permitted by law to make secret price concessions to favored buyers, the effectiveness of the cartel in maintaining oligopoly prices is likely to be undermined. This would occur because the grantor of the price concession will attract business from the other cartelists. They may then be forced to follow suit with the probable result that

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202 Neal Report, *supra* note 200, comment to § 2(b)(ii), at 19. For evidence of existing practice, *see* National Dairy Products Corp. v. FTC, 395 F.2d 517, 521 (7th Cir. 1968), *cert. denied*, 393 U.S. 977 (1968); Corn Products Ref. Co. v. FTC, 324 U.S. 726, 742 (1945); Areeda and Turner, *supra* note B3, at 726-27. *See generally* Rowe, *Section 2(a) of the Robinson-Patman Act: New Dimensions in the Competitive Injury Concept*, 37 A.B.A. ANTITRUST L.J. 14, 16-17 (1968).

203 *See* Sections II and III, respectively, *supra*.

204 *See, e.g.*, C.D. EDWARDS, THE PRICE DISCRIMINATION LAW 208 (1959), at 542-545. *See also* Adelman, *Effective Competition and the Antitrust Laws*, 61 HARV. L. REV. 1289, 1330-32 (1948) (price discrimination facilitates primary-line competition).

prices will undergo a general reduction. Thus the primary line policy of reducing oligopoly price rigidity is served by permitting each cartelist to make selective price concessions.

But secondary line competition may be damaged by this same price concession practice. Competitors of the favored buyer who, because of their smaller size, cannot induce the cartel member to grant them an off-list reduction, will be less able to compete with the oftentimes large, favored buyer, even though they may be equally or more efficient. It was to guard against precisely this kind of secondary-line anti-competitive effects that the RPA was enacted.[205] Thus the present Act generally favors secondary-line competition at the expense of primary-line competition,[206] although the meeting-competition defense reduces this imbalance somewhat.[207]

We propose a new series of compromises between secondary-line protection and primary-line protection. These compromises are related to the marginal-cost principles developed in the non-discriminatory and discrimination-without-secondary-line-injury cases already discussed.[208] Our analysis here is divided into several categories, depending on whether the pricing practices under analysis are above or below marginal cost, and on whether they are pursued by small or large producers.

1. Below-marginal-cost pricing

We have already concluded that below-marginal cost pricing generally should not be allowed, even if it is completely non-discriminatory, or discriminatory but without secondary-line effects.[209] There is even less reason to allow such below-marginal cost pricing where the price in question is lower than a price charged by the same seller to other customers in the same market

205 *See* note 1 *supra*.

206 The prohibition of price discrimination may restrict "one of the most powerful forces of competition in modern industrial markets" on the primary line. Adelman, *Effective Competition and the Antitrust Laws*, 61 HARV. L. REV. 1289, 1331 (1948).

207 *See* text accompanying notes B13j1 *supra*. That is, a price discriminating oligopolist whose actions have caused secondary-line injury can defend himself on the grounds that he was meeting the price cut of a (primary level) competitor.

208 *See* text accompanying note 192 *supra*.

209 *See* text accompanying note 192 *supra*.

as the favored buyer. Competition at the secondary line will probably be hurt by allowing a customer to use his bargaining power to exact price concessions not available to other customers who may be equally or more efficient, but less powerful than the favored customer. That a less efficient customer may be driven out of the market by this below-marginal cost pricing is not a persuasive response to this argument given that this less efficient firm could be forced out by above-marginal cost pricing or competition on the merits. Therefore we conclude that the same rules which bar below-marginal cost pricing in general apply equally to the situation in which secondary-line injury is promoted by such pricing conduct.

However, in the case where there are uniform prices across markets we concluded above that small producers should be exempted from the prohibition on below-marginal-cost pricing in two situations: (1) where the small seller is pursuing a valid promotional pricing strategy;[210] and (2) where he is meeting the price of a competitor.[211] Should these exceptions also be allowed where their effect would be to permit the small buyer to charge different prices to customers within the same market? Our answer is moderately complex, and requires that the two defenses be considered separately.

a. Promotional pricing—We have concluded that it is desirable to allow a small producer to pursue a below-marginal cost promotional pricing scheme, even if to do so he charged a lower price in one market than in the others in which he sells.[212]

In determining whether to allow such promotional pricing schemes where the small seller charges a low, promotional price to some customers in a given market, but not to others in that market, conflicting considerations arise. Competition in the seller's market is enhanced, since the small seller gets a chance to gain a foothold. But competition in the buyer's market may be injured, since those customers who do not get the benefit of the promotional price will be less able to compete with those who do, even though they may be equally or more efficient.

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210 *See* text accompanying note 161 *supra*.
211 *See* text accompanying note 169 *supra*.
212 *See* text accompanying note 161 *supra*.

However, on balance, we conclude that in most cases the desirable primary-line effects of allowing small producers to engage in below-marginal cost promotional schemes outweigh the detrimental effects on secondary-line competition. For two reasons, the secondary-line ill-effects will not be very serious. First, such promotional pricing schemes are by definition of non-permanent duration, and their duration would be limited to six months.[213] In this temporary period, it is unlikely that secondary-line competition will be seriously injured, whereas the benefits of promotional pricing in facilitating new entry and in helping small firms to challenge large ones could prove to be of lasting value to the state of competition in the primary-line market. Another factor tending to reduce secondary-line injury is the fact that the promotional scheme is allowed only to the small producer, by definition one who supplies a relatively small percentage of the market. Because of its small sales, the advantages gained by favored customers probably will not be sufficiently large to endanger disfavored customers or competition in the market generally. The benefits to the small primary-line producer in gaining a foothold in the market, however, are likely to be substantial.

A per se allowance of the promotional pricing to small sellers has the additional advantage of avoiding a situation whereby the FTC and courts adopt a case-by-case balancing approach. Such an approach can only result in uncertainty on the part of small sellers as to the availability of the defense to them.

Therefore, we would allow a small producer to engage in below-marginal-cost promotional pricing even if, to do so, he charged different prices within a given market.

b. Meeting competition defense — Our proposed revision would also allow small producers to assert the meeting-competition defense, whether or not the price they met was lawfully or unlawfully charged.[214] We would permit the use of this defense both where no price discrimination is involved[215] and where the price discrimination involved did not cause secondary-line injury, for example, where *all* customers in a given market received the

213 *See* text accompanying note 167 *supra.*
214 *See* model statute § 4(b) *infra.*
215 *See* text accompanying note 169 *supra.*

same price, even though that price was lower than in another market.[216] On the other hand, we would allow a small seller to price discriminate in favor of a *particular* customer in response to the low price of a competitor only in certain circumstances.

Observe that when a seller meets the low price offered to a customer by one of the seller's competitors, and the small seller does not offer this low price to his other customers in that market, secondary-line injury does not necessarily occur. For instance, assume that: (1) National Firm charges one of its favorite customers, Buyer 1, $100 per unit, and charges all of its other buyers $110; (2) National Firm has a sufficiently large capacity such that it can meet all of Buyer 1's requirements for the product; and (3) Regional Firm, also a seller of the product, wishes to meet National Firm's price to Buyer 1 of $100 while continuing to charge $110 to its other customers within Buyer 1's market. It is true that National Firm's pricing policy may injure competition on the secondary line in that other buyers may be unable to compete with Buyer 1 because they cannot get the product as inexpensively as he can. But if Regional Firm meets National Firm's offer to Buyer 1, these competitors of Buyer 1 are no worse off than they were before, since it makes no difference to them whether Buyer 1 buys at $100 from National Firm or at $100 from Regional Firm. Thus to permit Regional Firm to meet competition in this case, where National Firm could supply all of the buyer's requirements, produces no additional secondary line injury.

However, where National Firm cannot, or will not, supply all of Buyer 1's requirements at the low $100 price, competitors of Buyer 1 will be additionally injured if Regional Producer meets the $100 price to Buyer 1. Buyer 1 will then be able to purchase more of the product at the low price and his overall costs of production will be lower. Thus, in this situation, additional secondary-line injury would occur as a result of allowing Regional Producer to meet National Firm's price.

The importance of determining whether additional secondary-line injury would occur if the meeting-competition defense were allowed in a particular situation was recognized by the Supreme

216 *See* text accompanying note 194 *supra.*

Court in *Standard Oil Co. v. FTC.*[217] In *Standard,* the defendant had met the lawfully-charged price of a competitor. Standard's matching offer, however, was made only to the recipient of the competitor's offer, and not to other customers of Standard who competed in the same market as the recipient. The Court attached great importance to the fact that no additional injury to these other customers had occurred as a result of Standard's meeting its competitor's price.[218] The Court held that this fact, coupled with the fact that to allow Standard to meet competition might well promote competitive pricing at the primary line, required that the meeting-competition defense be allowed.[219]

Standard is, of course, an "easy" case in the sense that primary line policies were served by allowing the meeting-competition defense, and little, if any, additional secondary-line injury resulted from allowing it. But where additional secondary-line injury would occur if the small producer were permitted to meet competition,[220] one is forced, as in the promotional pricing case,[221] to choose between the protection of primary-line and secondary-line competition. Nor is a balancing approach any more workable here than in the promotional pricing situation — a small seller must be given some assurance, before he meets a price that is below his marginal cost, whether that conduct is lawful.

We conclude that where additional injury to secondary-line competition would occur by allowing the small producer to price below marginal cost to meet a rival's price, the small producer ought not be permitted to do so. The value of the meeting-competition defense was not altogether clear even in the non-discriminatory situation.[222] In fact we allowed the defense to small producers because of benefits which might, but were not certain to occur.[223] Here, where substantial injury to secondary-line competition may be involved (and where at least *some*

217 340 U.S. 231 (1951).
218 *Id.* at 250.
219 *Id.* at 251.
220 *See, e.g.,* text in paragraph preceding note 217 *supra.*
221 *See* text accompanying note 213 *supra.*
222 *See* text accompanying note 140 *supra.*
223 *See* text prior to note 154 *supra.*

additional injury is, by hypothesis, involved), we conclude that the somewhat speculative primary-line benefits of the meeting-competition exception are outweighed by secondary-line considerations.

Therefore, we would allow the small producer to meet a competitor's price for one customer but not for others in the same market only if his action would not cause additional secondary-line injury. In practical terms, this means that the small producer may meet a rival's price to a particular buyer only if that buyer can already fill all of his requirements from the rival at the rival's low price. We would place the burden of demonstrating that this was in fact the case on the small producer. He could meet this burden by requiring the buyer in question to produce, before the rival's price is met, a written statement to the effect that the buyer can satisfy all his requirements by buying from the rival at the rival's low price.[224] Note that this rule does *not* prevent a small producer from meeting below-marginal cost competition by making his low price available to *all* buyers in the market, for such conduct does not produce secondary-line injury.

2. Above-marginal-cost pricing

We now turn to a consideration of the situations in which a producer should be allowed to charge two different prices, within a given market, where both prices are above his marginal costs.

a. Where no additional injury would result — It was concluded above that above-marginal-cost pricing should never be prohibited on primary-line grounds. Thus we allowed such pricing both where no discrimination at all was involved,[225] and also where the discrimination involved was only amongst, and not within, markets.[226]

We similarly concluded that where above-marginal-cost price discrimination would not produce additional secondary-line injury, it should be allowed. This principle means, for practical purposes, that any producer, large or small, may charge an above-

224 *See* model statute §§ 12-13 *infra.*
225 *See* Section III(A) *supra.*
226 *See* Section III(B) *supra.*

marginal-cost price which meets the price offered by a rival to a particular customer, if the rival is willing and able to supply all of that customer's requirements at that price. As in the case of the small producer pricing below marginal cost in order to meet a rival's price, the seller can make the necessary showing that no additional secondary-line injury would have occurred by procuring from the buyer a statement that the buyer could purchase all of his requirements from the rival at the price to be met.[227]

The meeting-competition case is the only situation which we can envisage in which price discrimination within a given market could be carried on without additional secondary-line injury. This results from the fact that, in meeting-competition cases, one competitor has already caused secondary-line injury by offering a discriminatory low price to only one buyer. The initial existence of injury makes possible price discrimination by a competitor without additional injury, since his behavior may duplicate, although not extend, the effects of the first competitor's discrimination. No such duplication of effects is possible in any other situation.[228]

b. Where additional injury would result — We would apply a general rule prohibiting price discrimination which has secondary-line injurious effects, even where all prices were above marginal cost, except in the case of a small seller engaged in promotional pricing. The arguments, given above,[229] in favor of such an exception where the seller prices *below* marginal cost are surely as strong, if not stronger, when his prices are still *above* marginal cost.

In all other situations, however, we would not allow a seller to arbitrarily set a price differential within a given market, where no rival's price is being met. Such a differential would inevitably involve secondary-line injury, since by hypothesis the favored customer could not obtain his requirements anywhere else at the price in question. Similarly, we would prevent a producer

227 *See* model statute § 12 *infra*.

228 It is, of course, possible that the price discrimination within a given market will be so minor that it does not give rise to "secondary-line competitive injury," which we define in model statute § 4 *infra*.

229 *See* text accompanying note 213 *supra*.

from meeting competition through an above-marginal cost price that is lower than that charged by the producer to other customers in the particular market, if the recipient of the low price cannot establish that he could meet all of his requirements from the rival seller at the rival's low price.

Our reasoning for such a rule is as follows: In the situations described in the preceding paragraph, to allow a price differential would promote competition on the primary line, but injure it on the secondary line. As in the case of the small producer wishing to meet competition by below-marginal-cost pricing where additional injury would result,[230] we conclude that the protection of secondary-line competition is more important. It is our impression that small producers are in substantial danger of being eliminated by the granting of above-marginal-cost price concessions to large purchasers, and that the protection of such small purchasers is a worthwhile goal for market structure reasons. Furthermore, to favor secondary rather than primary-line competition in this situation is more in keeping with the original purposes of the RPA, and represents a less-radical change from the present Act than would a contrary rule.

THE SUBSTANTIVE PROVISIONS OF A REVISED PRICE DISCRIMINATION AND PREDATORY PRICING STATUTE

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230 *See* text accompanying note 222 *supra*.

Section 1. *Short Title*

This Act may be cited as The Price Discrimination and Predatory Pricing Act.

TITLE I: PRIMARY LINE PROHIBITIONS AND DEFENSES

Section 2. *Threats of Economic and Physical Harm*

It shall be unlawful for any seller engaged in commerce to overtly threaten a potential or actual competing seller with economic or

physical harm where such threats actually or might reasonably be expected to cause or induce the competitor:

> **(a) to conform to pricing policies favored by the seller; or**
>
> **(b) to cease or refrain from selling any product within a geographic area, or to cease or refrain from selling any product to any particular customer;**

regardless of whether any overt action is taken to fulfill such threat.

COMMENT: This section is intended to prevent any firm from overtly threatening any competitor with "economic" or "physical" harms[231] where the effect of such threats has an actual or reasonably expected effect on a competitor's marketing strategy. This prohibition is designed to encourage competitive pricing by ensuring that each firm will have direct control only over its own pricing and marketing tactics. The section is triggered only by overt verbal or physical acts; thus where one firm's price behavior only tacitly transmits signals to another firm, no violation of the section occurs.

The section prevents a firm from threatening the commission not only of acts which are forbidden by the rest of the Act, but even of acts which would themselves be lawful. Thus a firm would violate Section 2 if it threatened price cuts, even where the cut itself would be lawful under this Act. The purpose of prohibiting threats of actions which would be lawful under the other provisions of the Act is to induce the sellers to make the actual price cuts thus promoting competition and to avoid the *in terrorem* effect threats of retaliatory price-cuts may have beyond the pro-competitive effects of actual price cuts.[232]

This section differs from Section 2 of the Justice Department proposal[233] in two respects. First, our Section 2 explicitly prohibits not only threats which actually cause or induce harm, but

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231 For definition of "economic" and "physical" harm, see §§ 17(c), 17(g), respectively, *infra*.

232 Insofar as this section penalizes "threatening" conduct by small firms (*i.e.*, firms without market power) it represents an expansion of liability for smaller firms under Sherman Act § 2, 15 U.S.C. § 2 (1970). *See* notes 116-24 and text accompanying *supra*.

233 Justice Report, *supra* note 5, RPA Reform Statute § 2.

also those which can "reasonably be expected" to cause or induce harm. The Justice Department proposal through its sole reliance on the word "induce" leaves this question somewhat unclear.

Second, the terms "seller" and "product" are defined in Section 17(i). These definitions are broad, so as to include not only the provision of goods, but also of services.

With these exceptions, this section is identical to Section 2 of the Justice Department proposal.

Section 3. *Primary Line Prohibitions*

It shall be unlawful for any seller of a product to charge on a sustained basis a price or fee for that product which is below the reasonably anticipated average direct operating expense incurred in supplying that product where such product is sold, leased, or provided for use, consumption, or resale within the United States, the District of Columbia, or any other territory under the jurisdiction of the United States.

COMMENT: This section prohibits pricing that is so low that competition on the merits by rivals of the seller may be threatened. The price floor set by the section is the "reasonably anticipated average direct operating expense" incurred in supplying the commodity or service.[234] This measure is intended to be a more easily calculated substitute for marginal cost, the measure which is in abstract economic theory the most desirable price floor.[235]

The section applies only to pricing practices which are of a sustained duration as defined in Section 17(j) as a period of more than 60 days within any year-long period. This somewhat arbitrary limitation of the section's applicability reflects the view that non-discriminatory pricing practices are unlikely to pose a severe threat to competition in the seller's industry when they are pursued for fewer than 60 days within any year-long period. This exemption of short-term pricing strategies from the section should be contrasted with the limitations on discriminatory pricing set forth in Section 5; the latter apply even to short-term,

234 *See* § 16 *infra* for definition.
235 See Comment to § 16 *infra.*

or even one time discriminatory pricing practices which would otherwise fall within the provisions of Section 5.

The section is intended to be prophylactic. That is, it forbids certain pricing practices regardless of whether the practitioner has any kind of "predatory" intent. The section is different in this respect from Section 2 of the Sherman Act,[236] and Section 3 of the Robinson-Patman Act,[237] both of which require some kind of wrongful, anti-competitive, intent.

A seller is liable under the section even if he is not aware that his price is below his reasonably anticipated average direct operating expenses; he may not avoid liability by refusing to conduct the accounting needed to determine these expenses.

This section bears a close resemblance to Section 3 of the Justice Department proposal. The principle difference is the extension of coverage to leases of commodities, and to the provision of services.[238] It differs from the present law in that it provides a clear standard with a sound economic basis.[239]

Section 4. *Primary Line Defenses*

It shall be a defense to a violation of Section 3 that an otherwise unlawful price:

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236 *See, e.g.*, United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966); Kansas City Star Co. v. United States, 240 F.2d 643, 660 (8th Cir. 1957), *cert. denied*, 354 U.S. 923 (1957); United States v. Aluminum Co. of America, 148 F.2d 416, 431-32 (2d Cir. 1945), *certified and transferred from S. Ct.*, 322 U.S. 716 (1943) (quorum absent).

237 Section 3 of the Robinson-Patman Act, 15 U.S.C. § 13a (1970), establishes criminal penalties, but no private right of action, for three distinct offenses:

(1) Knowingly entering into a sale transaction which discriminates against competitors of the purchaser;

(2) Selling or contracting to sell goods in any part of the United States at prices lower than those exacted elsewhere in the United States, for the purpose of destroying competition or eliminating a competitor;

(3) Selling or contracting to sell goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.

The first of these offenses overlaps largely with the basic provision of the Act, § 2(a), and is little used. The other two require a specific wrongful intent. Section 3 is entirely eliminated from our proposed revision, as it is from that of the Justice Department and the Neal Report. Justice Report, *supra* note 5, and Neal Report, *supra* note 200. The basic evil at which the section is aimed, predatory pricing, is forbidden by § 3 and § 5 of the proposed revision, *infra*.

238 *See* § 17(i) *infra*.

239 *See* text accompanying note 151 *supra*.

(a) was charged by a small seller in order to meet in good faith the equally low price of a competitor;

(b) was charged by a small seller as part of a promotional pricing scheme;

(c) was charged in response to changing conditions affecting the market for or the marketability of the commodities involved, including, actual or imminent deterioration of perishable commodities, obsolescence of seasonal commodities, distress sales under court process, or sales in good faith in discontinuance of business in the commodities concerned; or

(d) did not threaten the elimination from a line of commerce of a competitor of the person charging the otherwise unlawful price.

COMMENT: This section sets forth several affirmative defenses which must be raised by one charged with violating Section 3. It is intended that the defendant have the burden of pleading and proving these defenses.

Section 4(a) grants the "meeting-competition" defense to "small sellers," who are defined in Section 17(k) as sellers with a less-than-three-percent market share. No one other than a small seller may assert the defense that he was meeting the price of a competitor; the proposal is in this respect different from the Justice Department proposal which would permit the defense to any seller. The reasons for not allowing the defense to large sellers, and for granting it to small ones, have been detailed elsewhere.[240]

Section 4(b) grants a second defense to a small seller, namely, the defense that the price was charged as part of a promotional pricing scheme.[241] It is intended to apply only to promotional pricing practices lasting longer than 60 days;[242] practices of a shorter duration are not covered by Section 3 at all, regardless of whether the seller is large or small. The Justice Department proposal does not utilize the concept of a promotional pricing scheme. However, the Justice Department proposal would permit any conduct falling within the promotional pricing exception of our proposal, since it permits small sellers to pursue any non-

240 *See* text accompanying note 116 *supra.*

241 For the reasons for denying the "promotional pricing" exemption to non-small sellers, *see* text accompanying note 161 *supra.*

242 *See* § 17(j) *infra* and § 3 *supra.*

discriminatory scheme at all.[243] Note that this defense is not recognized under current law.[244]

Section 4(c) allows any seller, whether large or small, the defense that the below-average-direct-operating-expenses price was charged in response to changing market conditions. A similar defense is allowed, in the context of price discrimination, by the last proviso to Section 2(b) of the Robinson-Patman Act. The purpose of Section 4(c) is to exclude from the prohibition in Section 3 below-cost sales which are not part of an on-going course of dealing, but are instead an effort to obtain the salvage value of goods whose value has been reduced below cost because of unforeseen market changes. The Justice Department would also grant this defense, on the same terms.[245]

Section 4(d), although phrased in the form of an affirmative defense, is in fact a definition of what constitutes injury to competition for purposes of Section 3. The purpose of Section 3 is to protect competition in the seller's industry; the protection of competition in the buyer's industry is governed by Section 5, involving price discrimination. Because there is no reason to prohibit conduct which would not impair competition in the seller's industry, Section 4(d) exempts such non-harmful conduct from Section 3's purview although the burden is on the defendant to show that the conduct did not have certain anti-competitive effects. Section 4(d) represents an express repudiation of the generally-discredited "diversion of business" test for injury to competition.[246] Section 4(d) imposes a higher threshold for measuring injury on the primary line (the seller's industry) than the loss of business sufficient under the diversion of business test. It permits conduct otherwise prohibited by Section 3 if the injured competitor of the seller is not threatened with being forced by economic pressures to discontinue a product line.

This standard of injury, although stricter than the "diversion of business" test, is less strict than that proposed by the Neal statute.[247] That statute would require, in price-discrimination

243 Justice Report, *supra* note 5, RPA Reform Statute § 4(b).
244 *See, e.g.*, Utah Pie v. Continental Baking Co., 386 U.S. 685 (1967).
245 Justice Report, *supra* note 5, RPA Reform Statute § 4(c).
246 *See* text accompanying note 53 *supra*.
247 Neal Report, *supra* note 200, at 18-19.

cases not involving secondary line injury, that the pricing practice:

> ... imminently ... [threaten] ... to eliminate one or more competitors whose survival is significant to the maintenance of competition in that area.
>
> Provided, however, that the survival of a competitor is not significant to the maintenance of competition where, in the line of commerce or area affected, the number of competitors remaining, or the ease with which new competitors may enter, indicates that effective competition will not be suppressed for an appreciable period of time.[248]

The commentary to this section of the Neal statute emphasizes that its purpose is to prevent the courts from focussing on the plight of individual competitors, and to make them base their decision on broader, industry-wide, competitive effects.[249] Since our proposal addresses only below-cost pricing in the primary line area, there is less need to fear that courts will apply it in a manner which limits competition. Thus the tests for competitive injury can be less stringent.

Our adoption of this "elimination of product line" test has the virtue of being more easily administrable than the Neal approach, since the latter requires a court to determine whether the survival of the injured competitor is "significant to the maintenance of competition," a task more difficult and less amenable to judicial resolution than the issue of whether a seller is threatened with elimination from a line of commerce. For similar reasons the incorporation of the substantially-lessening-competition test of Section 7 of the Clayton Act is shunned.[250]

TITLE II: SECONDARY LINE PROHIBITIONS AND DEFENSES

Section 5. *Secondary line prohibitions*

It shall be unlawful for any seller to charge to a customer a lower price, either directly or indirectly, for a product than the seller charges

248 *Id.* at 18.
249 *Id.* at 19.
250 15 U.S.C. § 18 (1970).

to competing customers for a product of like grade and quality, if both of the products in question are provided for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, where:

(a) the favored customer is in competition with the disfavored customer; and

(b) the difference between the price charged to the disfavored customer and that charged to the favored customer:

(i) is part of a pattern which systematically favors customers purchasing large quantities of the good over customers purchasing smaller quantities; or

(ii) enables the favored customer to resell the product or services at a lower price than that at which he would sell it if he were charged the price charged to the disfavored customer; or

(iii) eliminates or threatens to eliminate the disfavored customer from a line of commerce.

COMMENT: This section supplies the basic prohibition on price discrimination. Two conditions must be filled before a violation of the section occurs. First, the favored customer must be in competition with the disfavored customer. Secondly, the price differential must either (i) occur as a result of the seller's overall pattern of charging lower prices to the purchasers of large quantities than to the purchasers of smaller quantities, or (ii) have an effect on the resale price of the product, or (iii) threaten to cause the disfavored customer to discontinue a "line of commerce."[251]

Section 5 is intended to prohibit only those pricing practices which have important, clearly defined, and undesirable "secondary-line" consequences. Price discrimination with only primary line consequences is governed solely by Section 3, and is treated the same as non-discriminatory pricing. Section 5(a) requires that the favored and disfavored customers be in competition with each other. Where the disfavored customer is not in competition with the favored customer, competition in the secondary line could not possibly be affected by the discrimination,

251 *See* § 17(f) *infra* for definition of "line of commerce."

and no violation of Section 5 is deemed to have occurred. Similarly, if the discrimination is neither a part of a general pattern favoring large purchasers, nor affects the resale price of the product, nor threatens to eliminate the disfavored customer from selling that product in any market, the secondary level effects of the discrimination cannot reasonably be said to be substantial, and the discrimination is therefore not prohibited by Section 5.

The test of Section 5(b)(i) is met only where the discrimination is part of a general pattern of higher prices to smaller customers. It is not the absolute size of the customer that is relevant under this test, but the proportion of purchases made by the particular customer from the seller. The test is not met if only a small fraction of the large customers of the seller receive the discrimination, or if the discrimination is only occasional. The test is designed to avoid further rigidity in oligopoly pricing conduct. However, either of the other two tests of Section 5(b) could be met where the discrimination is occasional, or not granted to large buyers generally.

The test given in Section 5(b)(ii) embodies the Supreme Court's test for secondary-line injury in *FTC v. Morton Salt Co.*[252] There the Court held that the price differential on salt in question was sufficiently great to make a difference in the resale price of the salt and thus represented a violation of the RPA.

The test in Section 5(b)(iii) would be met whenever the price differential causes or threatens to cause the disfavored customer to abandon the selling of the product in question in a particular geographic market, to a particular class of customers. This test would be met if, for instance, the disfavored customer were forced to stop supplying a product to retail customers in San Francisco, even if it were able to continue selling that product to all of its former customers and were also able to sell other products to San Francisco retail customers. Nor does the product line which is eliminated have to be the particular line as to which the discrimination was granted; it might instead be a product for whose manufacture the disfavored customer utilizes the product subject to discrimination.

252 334 U.S. 37 (1948).

The Justice Department proposal would impose, in addition to most of the above requirements, the further requirement that the discrimination be "significant in amount."[253] We reject this requirement as being undesirable in some cases, and redundant in all others. In the case of a pricing policy favoring large purchasers over small ones, we do not believe that the small purchaser should bear the burden of showing the "substantiality" of the discrimination — administration of Section 5 will be much smoother without the necessity for judicial construction of a vague term such as "substantial." And in the situation where the differential affects resale price, or threatens the elimination of a product line, the discrimination is almost by definition "substantial."

The Justice Department proposal would not allow, as a substitute for a showing of a general pattern of large-versus-small-buyer-discrimination or of the threat of elimination of a product line, the showing that the resale price of the product would be affected. In our opinion, a disfavored customer deserves protection from discrimination if he can show that the discrimination is great enough to cause him to charge more than his competitor, even where he cannot show that the seller generally favored large buyers or that he (the disfavored customer) would have to give up selling the product entirely. A small customer who is charged a higher price merely because the seller happens to dislike him, and who then loses a few customers as a result of the high price, has in our view been sufficiently injured, and in a manner not related to "competition on the merits," that he should have relief under the Act.

Section 6. *Small Seller Defenses to Section 5*

It shall be a defense to a violation of Section 5 that the price charged to the favored customer was charged by a small seller, and was charged:

(a) in order to meet in good faith the equally low price of a competitor or competitors willing to supply all of the

253 Justice Report, *supra* note 5, RPA Reform Statute §§ 5(a) and 5(b).

requirements of the favored purchaser at that equally low price for the near future; or

(b) as part of a promotional pricing scheme.

COMMENT: Section 6 grants to small sellers only two defenses to violations of Section 5 not provided to larger sellers. The reasons for allowing these defenses are set forth in the text.[254]

The requirement of Section 6(a) that the competitor whose low price is to be met is able to supply all of the requirements of the favored customer at the low price, is an attempt to limit the meeting-competition defense to those cases where the disfavored customer will not be harmed further if the defense is allowed. Since the favored customer can, if Section 6(a) is met, already fill his requirements at the low price anyway, his rivals are not additionally injured by a second seller's matching of the low price.[255]

If more than one competitor has offered the low price which the seller desires to meet, he may do so if all of them together are willing to supply all of the favored customer's needs at that price, even if no single one of the competitors will do so. In such circumstances, the injury to competitors of the favored customer is not increased by application of the meeting-competition defense.

As a general rule, the Section 6(a) defense is available whether or not the price being met is itself lawful; the sole exception to this rule is in case of certain broad injunctive suits treated in Section 11.

Section 6(b)(ii) also grants small sellers a promotional pricing defense.[256]

The defenses allowed in this section apply whether the seller's price to the favored customer is at, above, or below average direct operating expenses.[257] The Justice Department proposal would allow the meeting-competition defense to *any* seller,

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254 *See* text accompanying note 212 *supra*.

255 For a fuller discussion of when additional secondary line injury may result from allowing the meeting-competition defense, *see* text accompanying notes 109-14 *supra*.

256 *See* text accompanying note 212 *supra*.

257 For the reasons for granting such broad scope to these defenses *see* text accompanying notes 118-69 *supra*.

whether large or small.[258] Furthermore, that proposal makes no attempt to distinguish between those cases where allowing the defense would cause additional secondary line injury, and those where it would not. It is our view that these two kinds of cases are sufficiently distinguishable, by reference to whether the competitor whose price is being met can already supply all of the buyer's requirements at the low price, that the meeting-competition defense should be eliminated in the additional-injury case. In this respect, our proposal probably would give disfavored customers more protection than they receive under the present Robinson-Patman Act, under which the absence of additional secondary line injury is not a prerequisite to the allowing of the meeting-competition defense.[259]

Section 7. *Limitation on Promotional Pricing Defense*

A seller shall not be permitted to rely upon any promotional pricing scheme as a defense to any violation of this act if within any 365 day period encompassing any date on which the alleged violation occurred, the seller pursued promotional pricing schemes with respect to the good in question for more than 180 days.

COMMENT: Sections 4(b) and 6(b) grant small providers a defense to otherwise unlawful practices if these practices are part of a "promotional pricing scheme."[260] Because such promotional schemes may, even though pursued by small firms, cause competitive injury,[261] these practices are limited to approximately six months per year. This duration should be sufficient to allow the promotion to gain brand-recognition for the product, without being so long that the promotion becomes a permanent policy. All promotional schemes are aggregated in order to determine whether the 180-day limit has been exceeded. For these purposes, a day counts as one day out of the 180 if any promotional scheme is in force on it, regardless of the number of such schemes in force on that day.

258 Justice Report, *supra* note 5, RPA Reform Statute § 6.
259 *See* Standard Oil Co. v. Federal Trade Commission, 340 U.S. 231 (1951).
260 *See* § 25(k) *infra* for definition of "promotional pricing."
261 *See* text accompanying note 212 *supra*.

Section 8. *Additional Secondary Defenses*

It shall be a defense to a violation of Section 5 that:

(a) the lesser price was in response to changing conditions affecting the market for or the marketability of the commodities involved, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned; or

(b) the lesser price was available, on reasonably practicable conditions, to the person allegedly discriminated against.

COMMENT: This section states two defenses to Section 5 defendants relating to changing market conditions as are granted to Section 3 defendants by Section 4(c). Section 8(b) provides a defense which is implied in the present Act, namely, that the discriminatory offer was granted to the person against whom the alleged discrimination was directed. This section is identical to Section 8 of the Justice Department proposal.

Section 9. *Cost Justification Defense*

It shall be a defense to a violation of Section 5 that the lesser price makes an appropriate allowance for differences in the cost of manufacture, distribution, sale, or delivery resulting from the differing methods or quantities involved in supplying the customers in question. An allowance is appropriate where the difference in price does no more than approximate the difference in cost; where the difference in price does not exceed a reasonable estimate of the difference in cost; or where the estimated difference in cost is the result of a reasonable system of classifying transactions which is based on characteristics affecting cost of manufacture, distribution, sale or delivery, under which differences in price among classes approximate differences in cost: *Provided,* that "cost" as used in this section shall be calculated consistently with the definition of "reasonably anticipated average direct operating expense" provided in Section 16 of this Act.

COMMENT: This section allows the "cost-justification" defense, permitted by the first proviso to Section 2(a) of the present

Robinson-Patman Act. Because of the difficulties under the current Act in using categories of customers for calculating costs,[262] this section explicitly allows "a reasonable system of classifying transactions" which is based on certain characteristics affecting cost. This language requires, as does present case-law, that the customers in each category share fairly similar cost characteristics. The proviso requires that costs be determined on the basis of the "additional" cost the seller incurred in providing the product to each particular class of customers, assuming the other customer classes were already being served.[263]

With the exception of this proviso, this section is identical to Section 7 of the Justice Department proposal.

Section 10. *Large Seller Meeting-Competition Defense*

It shall be a defense to a violation of Section 5 that the price charged to the favored customer was above the average direct operating expenses of the seller and was charged in order to meet in good faith the equally low price of a competitor or competitors able to supply all of the requirements of the favored purchaser at that equally low price for the next 60 days.

COMMENT: Section 6(a) allows a small producer to meet a rival's price if the rival can and will supply all of the customer's requirements at that low price, even if the small producer would have to sell at or below average direct operating expenses to meet that price. Section 10 allows *any* producer, even a large one, to meet the price of a rival under the same circumstances, as long as the producer, if he is not a small one, can do so without pricing below his average direct operating expenses. Permitting this defense in this context will not cause further injury to secondary line competition as it may have been in the first instance when the rival charged his price, if that price was offered only to the favored customer. Further, competition at the primary line will be enhanced.[264]

262 *See* text accompanying note 101 *supra*.

263 *See* § 16 *infra* for definition of "reasonably anticipated average direct operating expense."

264 *See* text accompanying note 225 *supra*.

All other aspects of the defense are the same as in Section 6(a). Thus even an unlawful price may, in most circumstances, be met. The "good faith" requirement of Section 10 is imposed largely for the purpose of preventing a producer or group of producers from selecting a 'stalking horse," who lowers his pice so that the others may meet it. The meeting-competition defense in Section 10, like that in Section 6(a), may be asserted only where the lower price was met in response to true competitive pressures exerted by the rival offering the original low price.

The rival whose price is to be met need not have promised to supply the buyer's requirements at that price indefinitely; it suffices that he is able to do so for the near future. Obviously, if the second seller responds to the rival's offer by meeting it, the former is not required to rescind his offer should it later develop that the rival is no longer offering that price.[265]

Section 11. *Unlawfulness of Met Price*

Except in a suit seeking only prospective relief against all or substantially all of the competitors granting a price differential in violation of Section 5, the defense set forth in Sections 6(a) and 8(b) and that set forth in Section 10 shall be permitted notwithstanding the fact that the equally low price of the competitor or competitors is determined to be unlawful.

COMMENT: Present law is unclear as to whether a seller may use the meeting-competition defense to match a price which he knows to be unlawful.[266] Section 11 adopts the general rule that where the defense is otherwise applicable, the fact that the price being matched is unlawful, and that the seller knows it to be, is irrelevant. The principal reason for this is one of administrability; it is more often than not difficult to establish judicially

265 The present law on this point is unclear. *Compare* Viviano Macaroni v. FTC, 411 F.2d 255 (3d Cir. 1969) (fact that petitioner continued price for three years without inquiring whether competitor's price was still outstanding was evidence that the purpose of discriminatory price was to favor large customer, not to meet competition) *with* Beatrice Foods & Eskay Dairy Co., 68 F.T.C. 348 (1965) (over one year period, no evidence that respondent was placed on notice that it was not justified in meeting previous offers of competitors for indefinite period).

266 *See* text accompanying notes 96-102 *supra*.

whether or not the seller knew that the price he was meeting was unlawful. Furthermore, the economic reasons for permitting a seller to respond to an unlawful price are stronger than those allowing a response to a lawful price, at least with respect to primary line policies.

The sole exception to this rule making the legality of the price to be met irrelevant, is where the suit is one for injunctive relief under Section 20 of this proposal against all or substantially all of those firms granting a discrimination falling within the prohibition of Section 5. This exception is designed to permit an injured buyer, as well as the FTC, to root out discrimination in an industry rampant with it, without the necessity for proving which firm started the unlawful pricing. As Section 11 indicates, the FTC must, if it wishes to avoid the meeting-competition defense, bring suit against all or substantially all of the firms practicing illegal discrimination. A private plaintiff suing for money damages is in effect required by Section 11 to find the firm which started the illegal conduct, or at least the firms which responded to that conduct by undercutting the illegal price.

TITLE III: VERIFICATION REQUIREMENTS

Section 12. *Verification Requirements Generally*

For purposes of Sections 6(a) and 10, a seller shall be deemed to have met the equally low price of a competitor or competitors willing to supply all of the requirements of the favored purchaser at that equally low price if:

> **(a) before or shortly after the seller offers to meet the equally low price, the favored purchaser signs a writing stating that a competitor or competitors has offered to supply all of the favored purchaser's requirements at the equally low price for the near future; or**
>
> **(b) the seller reasonably believes, at the time he offers to meet the equally low price, that a competitor or competitors of the seller has in fact made a bona fide offer to fill all of the favored customer's requirements at the equally low price for the near future: *provided,* that nothing in subsec-**

> **tion (a) or (b) of this section shall be construed to allow a seller knowingly to charge a lower price than that of the competitor to whose price he is responding: And *provided*, That any person signing a writing purporting to fall within subsection 9(a) who makes knowing misrepresentations in that writing shall be guilty of a misdemeanor and upon conviction thereof shall be fined not more than $100,000 or imprisoned for not more than one year, or both.**

COMMENT: Section 12 imposes the "verification" requirements for the use of the meeting-competition defense. The showing which must be made by a seller in order to assert the meeting-competition defense is subject to considerable uncertainty under the present Act.[267]

The purpose of Section 12(a) is to furnish the seller with a certain indication that his meeting-competition defense would be accepted if litigation ensues. Once he procures a writing described in Section 12(a), the fact that he was attempting to meet in good faith the equally low price of a competitor, and the fact that this competitor was willing to supply all of the buyer's requirements at that price, are conclusively established. Since the writing is meant to be a substitute for proof of the defendant seller's state of mind, this presumption cannot be undone even by a later showing that the buyer made intentional misrepresentations. Buyers will presumably be discouraged from making such misrepresentations by the sanctions set forth in Section 17(c).

One of the advantages of the "automatic verification" provision of Section 12(a) is that it renders it unnecessary for the seller ever to contact his rival, a desirable result for reasons set forth in the text.[268] Its other principal advantage is that it provides the seller with a means of being absolutely sure that he will not be subject to price-discrimination liability for the transaction, as long as he meets the applicable price-cost and producer-size requirements of the Sections 6(a) and 10 defenses. Since he can determine his fulfillment of these requirements from facts procured solely from his own business, his need to resort to information about what his rivals are doing will be minimized.

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267 *See* text accompanying note 77 *supra*.
268 *See* text accompanying notes 76-92 *supra*.

Section 12(b) gives the seller an alternative way of proving the meeting-competition defense, if he does not procure the writing described in Section 12(a). The "reasonable belief" test of Section 12(b) approximates the test of *FTC v. Staley Mfg. Co.*[269]

The proviso to Section 5 is intended to prevent a seller from knowingly undercutting, rather than matching, his rival's price. If such undercutting were permitted, the effort to prevent the use of the meeting-competition test where it would increase secondary line injury. If all other requirements of the applicable sections on meeting-competition are met, however, the defense is not vitiated by an unintentional undercutting of the price which generated the response.

Section 13. *Identity of Sellers*

(a) The writing described in Section 12(a) shall not be required to contain the identity of the competitor or competitors offering the equally low price, but shall be required to list the amount of the equally low price.

COMMENT: Section 13(a), which provides that the writing described in Section 12(a) does not have to contain the name of the rival whose price is to be met, is intended to avoid the undesirable results of unnecessary communication among oligopolists.[270] Although in certain respects competition in an oligopolistic seller's market might be injured even by the communication of price information without the names of the firms practicing it, the meeting-competition defense cannot function without the seller's knowing the amount of the price to which he is to respond. For this reason, and to minimize the possibility that the rival's price will be undercut rather than met (which would cause additional secondary line injury), the writing must contain the amount of the rival's offer.

The second proviso to Section 12(a) provides a deterrent to misrepresentations by buyers. It contemplates that buyers may be liable to those to whom the seller would otherwise be liable

269 324 U.S. 746 (1945). *See* text accompanying note 78 *supra.*
270 *See* text accompanying note 83 *supra.*

pursuant to Section 4 of the Clayton Act. This is the only provision for buyer liability in our proposal. Section 2(f) of the Robinson-Patman Act, providing liability for a buyer who knowingly receives a price discrimination, has been dropped. It is hoped that this will foster the advantages which come from hard bargaining by buyers.[271]

(b) A seller shall be deemed to fall within the requirements of Section 12(b) if he reasonably believes that some competitor or competitors has made a bona fide offer to the favored customer of a particular low price, even if the seller does not know the identity of the competitor or competitors.

COMMENT: Just as Section 13(a) makes a Section 12(a) writing valid if it does not contain the identity of the rival whose price is to be met, so Section 13(b) allows a seller making use of Section 12(b) rather than Section 12(a) to demonstrate a price verification without knowing the name of the rival. The reasons for this section are the same as those set forth in the Comment to Section 12(a).

TITLE IV. STANDING TO SUE

Section 14. *Primary Line Standing to Sue*

Any person suffering economic or physical harm from a violation of Sections 2 or 3, or from a pattern of conduct of which a violation of Section 3 is a part, shall have standing to bring suit against the violator, provided that the plaintiff is engaged in competition with the violator. In such a suit, the plaintiff's measure of damages shall be the amount necessary to compensate him for the economic and physical harm described in the first sentence of this Section.

COMMENT: This Section is intended to give any competitor of a seller who is injured by the seller's violation of Section 3 standing to sue. If a competitor of the defendant can show that the latter systematically priced below cost, and that certain other

271 *See* text accompanying notes 37-41 *supra.*

competitors were threatened with the elimination of a product line, the plaintiff competitor could recover even though the defendant's conduct only cost the plaintiff the loss of some business, and not the elimination of a product line. This provision would also encourage the bringing of multiple-plaintiff actions, since if one plaintiff proved injury sufficient to withstand Section 4(d), the others could also recover their damages.

Once the plaintiff proves a violation of Section 3, Section 14 establishes his damages as the full extent of his economic and physical harm.

Section 15. *Secondary Line Standing to Sue*

Any person who is a disfavored customer of a seller and who falls within Section 5 of this Act may bring suit against the seller for violation of Section 5. The plaintiff's measure of damages in such a suit shall be the amount necessary to compensate him for the economic and physical harm suffered by him as a result of the seller's violation of Section 5.

COMMENT: Once the disfavored customer establishes that he himself was injured in a manner forbidden by Section 5, his measure of damages is the amount which would put him in approximately the position he would have been in had the violation not occurred. His measure of damages is keyed to his economic and physical harm.

No competitor of a seller who violates Section 5 may bring suit under that section; it is restricted to those suffering secondary line injury. A seller may sue a competing seller under this Act only pursuant to Section 3.

TITLE V: DEFINITIONS

Section 16. *Reasonably Anticipated Average Direct Operating Expense*

(a) The "reasonably anticipated average direct operating expense" of supplying a particular product to a particular class of customers in

a particular market, shall be the "reasonably anticipted total direct operating expense" of supplying that product to that class in that market at or during the period of the alleged violation of Section 3 or Section 5 of this Act, divided by the total number of units of the product the seller reasonably anticipated providing to that class in that market during that time.

(b) For the purposes of this Act "reasonably anticipated total direct operating expense" shall be:

> (i) the dollar total of expenditures of every type, fixed and variable, which the seller reasonably could have expected to make in order to produce the total output of the product, at or during the period of the alleged violation of Section 3 and Section 5 of this Act, for all classes together; less
>
> (ii) the dollar total expenditures of every type, fixed and variable, which the seller reasonably could have expected to make in order to produce the total output of the product for all classes together except the class under consideration, at or during the period of the alleged violation of Section 3 and Section 5 of this Act.

(c) A reasonable system of classifying transactions which is based on characteristics affecting cost or manufacture, distribution, sale or delivery of the transactions shall be adopted in defining particular classes of customers, particular products, and particular markets.

COMMENT: "Reasonably anticipated average direct operating expense" is perhaps the most important term used in the proposed revision, and the term most difficult to define. While a producer's marginal costs theoretically can be defined with great precision, they are extremely difficult to measure in the real world. Producers almost never possess cost information which can tell them how much they must spend to increase output by a single unit; most cost analysis is done by reference to considerably larger changes in output. The definition given is intended to approximate the economist's idea of the "marginal cost" for supplying a particular product to a particular class of customers. The method of calculation described in the statute treats the production in a particular class as if it were the "last" class of items to be produced — although the class need not be the last class chronologically to which the seller has begun selling. Thus it more nearly approximates the economist's idea of the "marginal cost" of doing business to the particular class. While the marginal cost of producing a unit of a product might vary within a class, the figure calculated under the statute is an average of all the units produced in that class.

Section 17. *Other Definitions*

(a) "Commerce" shall have the same meaning as in Section 1 of the Act of October 15, 1914 (38 Stat. 730), commonly known as the Clayton Act.

COMMENT: "Commerce" is defined as it is in the Clayton Act, and is limited to the movement of commodities in interstate commerce, and the provision of services in interstate commerce. It does not apply to the provision of goods or services which is itself intrastate, but which affects interstate commerce.[272] This definition becomes operative in the Act through the definition of "seller," which applies only to those engaged in commerce.

(b) "Damages," as used in Section 14, shall be given the same meaning as the term "damages" as used in Section 4 of the Act of October 15, 1914 (38 Stat. 730), commonly known as the Clayton Act.

COMMENT: "Damages" are defined so as to be susceptible to tripling under Section 4 of the Clayton Act. The measure of damages in Section 3 suits is set forth in Section 14; that for Section 5 is stated in Section 15.

(c) "Economic harm" shall include any loss of revenues, any loss of profits, any loss of goodwill, and any withdrawal of credit, sustained by a person as a result of another's violation of any provision of this Act.

COMMENT: "Economic harm" is defined in an extremely broad manner, to include virtually every kind of pecuniary loss.

272 Gulf Oil Corp. v. Copp Paving Co., 419 U.S. 186 (1974).

The term is important in the calculation of damages under Sections 14 and 15. It is also of importance in determining whether a violation of Section 2 has occurred.

(d) "Favored customer" shall mean a customer who is charged a lower price for a good than is charged to any one other customer and who is in competition with such other customer.

COMMENT: "Favored customer" and "disfavored customer" are defined for purposes of Section 5's prohibition on price discrimination. The status of favored customer should be determined first — a customer is favored if he receives a lower price than any one other customer. A disfavored customer is then any competing customer who pays a higher price than the favored customer. Because the two terms are relative, a customer in a three-buyer market might be a favored customer with respect to one of his rivals, and a disfavored customer with respect to the other. Section 5 focusses on pairs of customers, and a seller's liability with respect to a particular pair of customers, one favored and the other disfavored, is not affected by the fact that the disfavored customer is favored with respect to some third customer.

By Section 15 only a disfavored customer may bring suit for a violation of Section 5; neither a competitor of the discriminating seller, nor a non-competing customer may sue.

(f) "Line of commerce" means the selling of a product within a particular geographic area to a particular category of customers.

COMMENT: "Line of commerce" is narrowly defined. For example, a firm which supplies each of two products to each of two kinds of customers within two geographic markets has eight lines of commerce. The term is relevant to the tests of injury to competition given in Sections 3(d) and 5(b) (iii).

(g) "Physical harm" shall include (i) physical damage to or destruction of real property, plants, buildings, equipment or other physical assets of a business enterprise or of those individuals managing, operating, owning or controlling a business enterprise, and (ii) physi-

cal injury to or physical intimidation of individuals engaged in managing, operating, owning or controlling a business enterprise;

COMMENT: "Physical harm," which is relevant only to Section 2 of the Act, is broadly defined. It includes not only property damage, but also injury to or other intimidation of persons running the business. This provision is identical to the Justice Department proposal.[273]

(h) "Price" shall mean the exaction of all consideration diminished by the granting of any brokerage, advertising, promotional, or other allowance, or the furnishing of services or facilities;

COMMENT: "Price" is defined very comprehensively, so that it includes all economic aspects of a transaction. Because the brokerage, advertising, promotional, and other allowances granted by a seller to his customer are deducted in calculating price, the provisions of Sections 2(c), 2(d), and 2(e) of the current Act, prohibiting discrimination with respect to these collateral services,[274] are rendered superfluous, and are eliminated.[275]

This definition is identical to that contained in Section 13(b) of the Justice Department proposal.

(i) "Product" includes commodities and services and "seller" means a person who sells, leases, or otherwise supplies a product in commerce.

COMMENT: "Product" and "seller" are broadly defined so as to extend the coverage of the Act to leases, and to services as well as commodities.

(j) "Promotional pricing scheme" includes any policy of charging a price for a good which is below the reasonably anticipated average direct operating expense of producing that good, and any policy of granting a difference in price with respect to a good which difference

273 Justice Report, *supra* note 5, RPA Reform Statute § 13(d).
274 15 U.C.A. §§ 13(c), (d), (e) (1970).
275 See § 21 *infra*.

in price falls within the meaning of Section 5 of this Act, consistent with Section 7 of this Act.

COMMENT: "Promotional pricing scheme" is defined so as to include both below-cost and discriminatory pricing practices. The term is relevant to defenses given to small sellers by Sections 4(b) and 6(b).

(k) "Small seller" means any person selling a product who at the time of sale accounted for less than three (3) percent of the gross revenue from provision of the product in the section of the country in which the sale was made.

COMMENT: "Small seller" is defined to include only firms with a smaller-than-three-percent market share in the product which they supply, in the particular market in question. The definition is important because of the defenses given to such providers by Sections 4(b) and 6(b).

The Justice Department proposal's definition of "new entrant"[276] is substantially equivalent to the definition of "small seller" given here, except that that proposal does not apply to any seller except a seller of commodities.

(l) "To sell on a sustained basis" shall mean to sell the commodity in question for more than 60 days within a period of one year.

COMMENT: "To sell on a sustained basis" is defined as selling for more than 60 days within a one-year, not necessarily calendar year, period. No sales made for a shorter period than 60 days fall within the sanctions of Section 3, although Section 5 prohibits price discrimination regardless of its duration. This period is, it is hoped, short enough that no severe competitive damage by below-cost pricing can occur within it, but long enough to give even large firms the opportunity to engage in some promotional activity. Small firms may conduct longer-term promotional pricing pursuant to Sections 4(b) and 6(b).

This definition is identical to the Justice Department proposal's definition.[277]

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276 Justice Report, *supra* note 5, RPA Reform Statute § 4(b).
277 *Id.* at § 13(f).

TITLE VI: MISCELLANEOUS PROVISIONS

Section 18. *Refusals to Deal*

Nothing herein contained shall prevent any person from refusing to deal with any person. An offer to deal only on discriminatory terms shall, however, be treated as a completed transaction for the purpose of according relief under this Act.

COMMENT: The first sentence of this section grants all sellers the right to refuse to deal with any particular customer, a right which is currently conferred by the third proviso to Section 2(a) of the Robinson-Patman Act.[278]

The second sentence of this section may represent a change from the present Act. Courts have generally held that two completed transactions are necessary for jurisdiction under the current Act;[279] this would require a customer who is discriminated against to accept the higher offer before being allowed to bring suit. This requirement is economically wasteful, and has therefore been eliminated.

This section is identical to Section 9 of the Justice Department proposal.[280]

Section 19. *Federal Trade Commission Act*

Section 5 of the Federal Trade Commission Act shall not be held to prohibit any discrimination in price for the sale of commodities, or the receipt of any such discrimination.

COMMENT: The Act attempts to define in a fairly definite manner the pricing practices which are and are not allowed. If, however, the FTC were free to use the extremely general language of Section 5 of the FTC Act against discriminatory practices, practices which are specifically authorized by this proposed revision might nonetheless be held illegal. Therefore, to insure

278 15 U.S.C. § 13(a) (1970).

279 Bruce's Juices, Inc. v. American Can Co., 330 U.S. 743, 755 (1947). *See also* Rowe, *supra* note 95, at 45-46.

280 Justice Report, *supra* note 5, RPA Reform Statute § 9.

that the policies of this proposed revision will be carried out, and to give sellers a greater degree of certainty regarding what is and is not unlawful, the FTC Act will have no applicability to discriminatory practices. This section is identical to Section 10 of the Justice Department proposal.[281]

Section 20. *Orders and Injunctions*

An order of injunction issued to restrain or prohibit a violation of Sections 5 through 9 shall remain in effect for a limited time, stipulated at the time of entry, and reasonably related to the nature of the violation. In no case shall an order issued to enforce such sections remain in effect more than five years after the date of entry.

COMMENT: Injunctive orders obtained by the FTC can apparently, like all court orders, continue indefinitely until their modification is procured. Because pricing practices must have a certain flexibility, such indefinite injunctions are undesirable in the pricing area. This section therefore requires the court issuing such an injunction to stipulate its length, and to set a length reasonably related to the substance of the violation.

This Section is identical to Section 11 of the Justice Department proposal.[282]

Section 21. *Repeal of Robinson-Patman Act*

Section 2 of the Act of October 15, 1914 (38 Stat. 730), commonly known as the Clayton Act, as amended, and Sections 1 and 3 of the Act of June 1, 1936 (49 Stat. 1528), commonly known as the Robinson-Patman Act, are hereby repealed. Any orders or decrees entered pursuant to the sections enumerated in the preceding sentence shall expire two years after the enactment of this Act, or sooner if they so provide.

COMMENT: This section repeals the current Robinson-Patman Act, which is replaced by this proposed revision. Any in-

281 *Id.* at § 10.
282 *Id.* at § 11.

junctions which are currently in force under that Act shall expire no later than two years after this proposed revision is enacted.

This section is identical to Section 12 of the Justice Department proposal.[283]

Section 22. *Antitrust Laws*

This Act shall be considered one of the "antitrust laws" for the purposes of Section 1 of the Act of October 15, 1914 (38 Stat. 730). Provided, however, that this Act shall not be construed to limit the applicability of other such antitrust laws.

COMMENT: This provision makes the proposed revision one of the "antitrust laws" as that term is used in Section 1 of the Clayton Act. The chief purpose of this denomination is to make the injunctive and treble damage remedies of the Clayton Act available to plaintiffs under the proposed revision. The damages which are to be trebled are those specified in Sections 14 and 15 of the proposed revision.

Section 22 does not validate any conduct which is forbidden by any of the "antitrust laws" as the Clayton Act uses that term, with the exception of the FTC Act. Thus a pricing policy which was followed in an attempt to monopolize would fall within the sanctions of Section 2 of the Sherman Act even though such pricing did not violate the proposed revision.

This section is identical to Section 21 of the Justice Department proposal.[284]

Section 23. *Fines and Penalties*

Any person violating Sections 2, 3, or 5 of this Act shall be guilty of a misdemeanor and upon conviction thereof, shall be fined not more than $100,000 or imprisoned for not more than one year, or both.

283 *Id.* at § 12.
284 *Id.* at § 21.

COMMENT: This section imposes criminal penalities for violation of the operative provisions of the Act. It is similar to Section 15 of the Justice Department proposal,[285] except that the latter does not impose criminal penalties for violation of Section 5, the price discrimination section.

Section 24. *Enforcement*

The Federal Trade Commission is hereby empowered to enforce the provisions of this Act as if they were provisions of the Act of October 15, 1914 (38 Stat. 730).

COMMENT: This section grants the FTC power to enforce the Act, to the same extent that the Commission may enforce the Clayton Act. In general, the Commission may seek either injunctions, criminal penalties, or both. This section is identical to Section 16 of the Justice Department proposal.[286]

APPENDIX

ROBINSON-PATMAN ACT REFORM STATUTE[287]

(* denotes sections contained in Predatory Practices Act)

Be it enacted, etc., that this Act shall be known as "Price Discrimination Act of 1975."

*Section 2. It shall be unlawful for the seller of a commodity engaged in commerce to overtly threaten a competing or potential competing seller of the commodity with economic or physical harm, so as to cause or induce the competing seller (a) to conform to pricing policies favored by the seller or (b) to cease or refrain from selling any commodity within a geographic area or to cease or refrain from selling any commodity to any particular customer; regardless of whether any overt action is taken to fulfill such threat.

*Section 3. It shall be unlawful for a seller of a commodity, engaged in commerce, knowingly to sell on a sustained basis such

285 *Id.* at § 15.
286 *Id.* at § 16.
287 Reprinted from Justice Report, *supra* note 5.

commodity at a price below the reasonably anticipated average direct operating expense incurred in supplying the commodity, where such commodity is sold for use, consumption, or resale within the United States, the District of Columbia, or any other territory under the jurisdiction of the United States.

*Section 4. It shall be a defense to a violation of Section 3 that an otherwise unlawful price:

(a) was charged by a person in order to meet in good faith an equally low price of a competitor;
(b) was charged by a new entrant, a person having at the time of sale a less than 10 percent share of the sales or the commodity in the section of the country in which the commodity was sold at such price being deemed a new entrant;
(c) was charged in response to changing conditions affecting the market for or the marketability of the commodities involved, such as but not limited to actual or imminent deterioration of perishable commodities, obsolescence of seasonal commodities, distress sales under court process, or sales in good faith in discontinuance of business in the commodities concerned; or
(d) did not clearly threaten the elimination from a line of commerce of a competitor of the person charging the otherwise unlawful price.

Section 5. It shall be unlawful to discriminate either directly or indirectly in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, where:

(a) the recipient of the discrimination is in competition with others not granted the discrimination, the discrimination is significant in amount, and the discrimination is part of a pattern which systematically favors larger recipients in the relevant line of commerce over their smaller competitors; or
(b) the recipient of the discrimination is in competition with others not granted the discrimination, the discrimination is significant in amount, and the discrimination clearly threatens to eliminate from a line of commerce one or more competitors of the recipient where the effect of such elimination may be substantially to lessen competition or to tend to create a monopoly in any line of commerce in any section of the country.

Section 6. It shall be a defense to a violation of Section 5 that the lesser price was charged in good faith to meet an equally low price of a competitor. Except in a suit seeking only prospective relief against all or substantially all of the competitors practicing the discrimination, the defense shall be allowed even if the equally low exaction of a competitor is subsequently determined to be unlawful.

Section 7. It shall be a defense to a violation of Section 5 that the lesser price makes an appropriate allowance for differences in the cost of manufacture, distribution, sale, or delivery resulting from the differing methods or quantities involved in supplying the customers in question. An allowance is appropriate where the difference in price does no more than approximate the difference in cost; where the difference in price does not exceed a reasonable estimate of the difference in cost; or where the estimated difference in cost is the result of a reasonable system of classifying transactions which is based on characteristics affecting cost of manufacture, distribution, sale or delivery, under which differences in price among classes approximate differences in cost.

Section 8. It shall be a defense to a violation of Section 5 that: (i) the lesser price was in response to changing conditions affecting the market for or the marketability of the commodities involved, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned; or (ii) the lesser price was available, on reasonably practicable conditions, to the person allegedly discriminated against.

Section 9. Nothing herein contained shall prevent any person from refusing to deal with any person. An offer to deal only on discriminatory terms shall, however, be treated as a completed transaction for the purpose of according relief under this Act.

*Section 10. Section 5 of the Federal Trade Commission Act shall not be held to prohibit any discrimination in price for the sale of commodities, or the receipt of any such discrimination.

Section 11. An order or injunction issued to restrain or prohibit a violation of Sections 5 through 9 shall remain in effect for a limited time, stipulated at the time of entry, and reasonably related to the nature of the violation. In no case shall an order issued to enforce such sections remain in effect more than five years after the date of entry.

*Section 12. Section 2 of the Act of October 15, 1914 (38 Stat. 730) commonly known as the Clayton Act, as amended, and Sections 1 and 3 of the Act of June 19, 1936 (49 Stat. 1528) commonly known as the

Robinson-Patman Act, are hereby repealed. Any orders or decrees entered pursuant to the sections enumerated in the proceeding sentence shall expire two years after the enactment of this Act, or sooner if they so provide.

*Section 13. As used herein:

(a) "Commerce" shall have the same meaning as in Section 1 of the Act of Ocober 15, 1914 (38 Stat. 730) commonly known as the Clayton Act;

(b) "Price" shall mean the exaction of all consideration diminished by the granting of any brokerage, advertising, promotional, or other allowance, or the furnishing of services or facilities;

(c) "Economic harm" shall include a reduction of revenue by sales at a price below the direct operating expense incurred in supplying the commodity, destruction of goodwill, or the withdrawal of credit without cause from a person;

(d) "Physical harm" shall include (i) physical damage to or destruction of real property, plants, buildings, equipment or other physical assets of a business enterprise or of those individuals managing, operating, owning or controlling a business enterprise, and (ii) physical injury to or physical intimidation of individuals engaged in managing, operating, owning or controlling a business enterprise;

(e) "Direct operating expense" shall include only direct costs of production and distribution associated with the particular sales of the commodities in question and only the portion of costs of depreciation, capital, leases of land and productive facilities, and general overhead of advertising, the incurring of which vary directly with the quantity of the commodity which is produced; and

(f) "to sell on a sustained basis" shall mean to sell the commodity in question for more than 60 days within a period of one year.

*Section 14. This Act shall be considered one of the "antitrust laws" for the purposes of Section 1 of the Act of October 15, 1914 (38 Stat. 730). Provided however, that this Act shall not be construed to limit the applicability of such antitrust laws.

*Section 15. Any person violating Sections 2 or 3 of this Act shall be guilty of a misdemeanor and upon conviction thereof, shall be fined not more than $100,000 or imprisoned for not more than one year, or both.

*Section 16. The Federal Trade Commission is hereby empowered to enforce the provisions of this Act as if they were provisions of the Act of October 15, 1914 (38 Stat. 730).

BOOK REVIEW

PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES. By *Stanley S. Surrey*, Cambridge: Harvard University Press, 1973. Pp. vii, 418, index. $12.00.

*Reviewed by Harry K. Mansfield**

The concept of "tax expenditures" has become a familiar one in tax legislation, even though its history goes back only to 1967, when Harvard Professor Stanley S. Surrey, then Assistant Secretary of the Treasury for Tax Policy, first presented the idea and the terminology.[1] Indeed, a tax expenditure budget, prepared by the executive branch, is now required as a part of the congressional budgetary process.[2]

In simplified form, the tax expenditure budget is a listing of major items in the nature of subsidies provided to taxpayers, corporate and personal, through the federal income tax, presented in a format similar to that employed to present appropriated federal expenditures. What makes the tax expenditure budget of special interest to all students of taxation, however, is that although its purpose is political, that is, to identify and quantify tax items which should be given scrutiny as governmental subsidies, its process is definitional: to review and classify those tax items which should not be treated as part of a normative income tax.

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1 During his eight years as Assistant Secretary of the Treasury for Tax Policy, Professor Surrey articulated his views of federal tax priorities in a number of messages and speeches. William M. Hellmuth and Oliver Oldman have edited many of these and gathered them into a useful collection, TAX POLICY AND TAX REFORM: 1961-1969 (1973). The first "tax expenditure budget" was prepared under Surrey's direction and presented to the Joint Economic Committee by the Secretary of Treasury in January 1969. Professor Surrey's own previous writings on this subject are numerous. *See, e.g.*, Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969); Surrey, *Tax Incentives as a Device for Implementing Government Policy; A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970); Surrey, *Tax Subsidies as a Device for Implementing Government Policy*, 3 TAX ADVISER 196 (1972).

2 *See* Congressional Budget and Impoundment Control Act of 1974, 31 U.S.C.A. § 11(e) (Supp. 1975), *amending* 31 U.S.C.A. § 11 (1970).

I. The Definitional Process

Professor Surrey sees the federal income tax as comprised of two major components:

> One part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Government financial assistance programs are carried out through special tax provisions rather than through direct Government expenditure (p. 6).

For classification of tax items into one part or the other, it is necessary to assume, as Professor Surrey apparently does, that there are generally accepted rules, customs, conventions and views of net income which should be incorporated in an income tax (pp. 15-24).

For the purpose of developing the tax expenditure concept, Professor Surrey rejects the notion of an "ideal" or theoretically pure income tax structure.[3] Such an emphasis would have directed the thrust of the book toward economic arguments and theories. Some tax commentators advocate that analysis of tax reform must begin at this point.[4] Instead, for Surrey's purposes, a model reflecting practical and administrative elements is chosen as being representative of today's income tax structure. Thus, in Professor Surrey's model, imputed income from owner-occupied property

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3 *Cf.* the Haig-Simons inclusive model: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." H. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

4 For example, Professor William D. Andrews, of the Harvard Law School, by reading literally the Simons' definition cited in note 3 *supra*, argues that the nature of an income tax should focus on "consumption" and "uses" of funds. Professor Andrews seems to doubt the utility of tax expenditure analysis for deductions from income in contrast to exclusions from income; or, at least, he questions the appropriateness of the analysis as applied to certain personal deductions. *See* Andrews, *Personal Deductions In an Ideal Income Tax*, 86 HARV. L. REV. 309, 314-15, 375 (1972). See also the exchange between Professors Andrews and Warren concerning the neutrality of the consumption-type tax in regard to the legitimate objectives of a basic tax system. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Warren, *Comment—Fairness and a Consumptions-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, *id.* at 947. *See generally* W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953); J. PECHMAN & B. OKNER, WHO BEARS THE TAX BURDEN (1974).

as well as unrealized changes in wealth are ignored as far as the definition of income is concerned (p. 12). The separate taxation of different entities, such as corporations, trusts, and individuals, and the different methods of accounting for income, such as cash receipts and disbursements or accrual, are not challenged. The existing basic income tax structure, with its progressive rates and exemptions, is postulated as the norm. Under the tax expenditure analysis, the search is to identify and segregate those remaining items that are not part of this "normal structure" of an administrable income tax but are reflective primarily of policy decisions to benefit either particular groups of taxpayers or particular transactions.

Professor Surrey's acceptance of the present income tax structure also tends to avoid critical questions of fairness and application which might have diverted attention from his primary point of the hidden political implications of indirect governmental subsidies in the tax code. Nevertheless, this approach enables Surrey to show a mosaic of special exclusions, exemptions, and deductions representing special sociopolitical points of view and to illuminate the conflicting economic interests vying for tax recognition. Some of these provisions essentially constitute a separate system of tax laws for certain activities where operation of the general rules would be difficult, such as the rules applicable to insurance companies,[5] mutual funds,[6] and banks.[7] Most of the provisions highlighted by the Surrey analysis constitute special tax benefits, such as the treatment given natural resources extraction,[8] farming,[9] and shipping.[10]

The enumeration of tax expenditure items can, of course, reflect differing opinions as to the appropriateness of their inclusion or exclusion. For example, the Surrey budget figures include unrepatriated profits of foreign subsidiary corporations and accelerated depreciation through the asset depreciation range

5 INT. REV. CODE OF 1954, §§ 801-44.
6 *Id.* §§ 851-55.
7 *Id.* §§ 581-86, 591-96.
8 *Id.* §§ 263(c), 613, 631(c), 1231(b)(2) (minerals); §§ 631(a)-(b), 1231(b)(2) (timbering).
9 *Id.* §§ 1231(b)(3)-(4), 175; Treas. Reg. 182, § 1.162-12, T.D. 7198, 1972-2 CUM. BULL. 166.
10 INT. REV. CODE OF 1954, §§ 883(a), 955(b) (foreign flag vessels).

(ADR), both of which the 1976 Budget, Special Analysis F, omitted.[11] On the other hand, the Joint Committee staff, in its third report on federal tax expenditures has again included these items, plus two additional ones: the maximum 50 percent tax on earned income, and accrued capital gains at death.[12] Other included and excluded items have been criticized by commentators.[13]

II. The Decision-Making Process

Clearly, a debate as to what elements are properly a part of an ideal income tax can be valuable. But more important is the selection and identification of items appropriate for periodic *policy* review by the executive branch and the legislature. The objective in presenting a tax expenditure budget is to ensure that the proper executive and legislative bodies make explicit determinations of the desirability of included items. Such a budgetary analysis raises questions not only of the merits of the separate items but also of the propriety of their review by the tax-writing congressional committees rather than the appropriations committees.

The normal process employed in Congress for determining the need for the expenditure of funds for socially desirable programs is both complicated and time-consuming. First, the proposed program must run a gauntlet of hearings and review by the committee having jurisdiction of the subject matter. The committee members and its staff will ordinarily have substantial experience and expertise. Opposing views will be openly presented and considered. The policy considerations associated with the program can be coordinated with, or contrasted to, existing programs by the body politically responsible for that subject area. Second, the program must then be funded after consideration by a separate set of appropriations committees which have an overall perspec-

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11 Special Analyses, Budget of the United States Government, 1976, 108-09 (1975).

12 BNA Daily Tax R. No. 174, J-1 (Sept. 8, 1975).

13 *See* Blum, Book Review, 1 J. Corp. Taxation 486, 489 (1975).

tive on budgetary matters. A direct expenditure can therefore become a coordinated piece of the total budgetary framework.

In contrast, provisions for tax subsidies, which "constitute by far the largest element in Government subsidy programs," (p. 7) represent a marked departure from this procedural pattern. The tax committees have expertise in tax writing but rarely in the relevant substantive area of the law. The same is true of the tax-writing committee's staff. And these committee hearings usually have a different emphasis and focus. Logically, a jurisdictional shift of so-called tax subsidy items to the appropriate substantive and appropriations committees would appear desirable, and Professor Surrey indicates approval of this goal.[14]

The functions of the new Congressional Budget Committees must necessarily touch these revenue allocation and spending matters. Their status as standing oversight committees places their large professional staff in the unique position of infusing new viewpoints into the consideration of expenditure items.

III. Impact on Tax Reform

The usefulness of the tax expenditure budget in producing significant tax reform can be suggested by examining the estimated amounts involved. The largest items listed in the 1976 Tax Expenditure Budget include the following: excess of percentage over cost depletion; the $25,000 corporate surtax exemption; exclusion of employer contributions for medical care and medical insurance premiums; medical expense deductions; OASI benefits for the aged; exclusion of unemployment insurance benefits; pension contributions to employer plans; exclusion of interest on state and local debt; deductibility of nonbusiness state and local taxes; investment credit; individual capital gains; deductibility of mortgage interest and taxes on owner-occupied homes; deductibility of charitable contributions; and deductibility of interest on consumer debt.[15] After exposure by expenditure analysis, the ques-

14 Professor Walter J. Blum, however, has argued that these items cannot be divorced from a consideration of the tax rates and so should continue to be lodged with the taxation committees. *See* Blum, Book Review, note 13 *supra* at 491.

15 *See* note 11 *supra*.

tion then becomes how many of these items might realistically be subject to elimination from the tax law. Some may be, as in the case of percentage depletion. Others, such as tax-exempt bond interest, may be transformed into direct expenditures. The final choice belongs to our elected policy makers in both the executive and legislative branches. Nevertheless, the process of removing any of these politically motivated items from the tax code, and the probability of thereby either increasing our tax revenues or reducing our tax rates by eliminating many of these "politically untouchable" items, will depend on the force of tax reform efforts in the next few Congresses.

Scrutiny of these items in respect to their "cost" to the government through lost revenue focuses attention upon the persons benefitted by these back-door subsidies. For particularly close analysis, Professor Surrey examines in detail the impact of three items in his expenditure budget: the tax exemption for interest on state and local government obligations (pp. 209-222); the deduction for charitable and educational support (pp. 223-232); and the support given private housing (pp. 232-246). As can be expected, the benefit — incentive is primarily attractive to corporations and high bracket individuals because of the upside-down effect on tax expenditures caused by our steeply progressive rates of taxation.[16] But tax expenditure subsidies are by no means solely beneficial to the wealthy, for reference to the list of the largest tax expenditure items indicates that many of them were beneficial to low bracket taxpayers or non-taxpayers, as in the case of exclusions of unemployment and OASI aged benefits (*see* pp. 8-11). A major impact of the book may well be to extend the analysis of tax expenditure items to consider the question of the fairness of allocating their benefits. Professor Surrey, however, seems reconciled for the present to use the tax expenditure analysis to accomplish a meaningful exposure of the practice of tax

16 Since most expenditure budget items are shaped in terms of exclusions or deductions from gross income, the amount comes off of the top layer of income to be taxed, and the ultimate benefit is determined by the taxpayers marginal tax rate. The higher that tax rate, the more valuable is the subsidy, *i.e.*, the greater is its worth measured in tax reduction dollars. For example, an exclusion of $100 to a taxpayer who would otherwise be in the lowest taxing bracket saves $14, while the same $100 exclusion is worth $70 in taxes saved to a taxpayer in the highest marginal bracket.

subsidies and to encourage procedural reforms in the enactment of tax legislation.

Conclusion

Pathways to Tax Reform is an important and seminal book, which has already had significant influence in shaping discussions about tax legislation. It has focused attention on the provisions appropriate to a normative income tax. It has highlighted many tax provisions conferring special benefits with attention to their revenue impact and, to a lesser extent, to their distributive impact.

Clearly, Professor Surrey seeks the removal of most of these hidden subsidies from the tax law. He does not object to substitute provisions, whether by way of direct grants, loans, interest subsidies, or guaranties of loan or interest repayments. He does conclude that "[t]he whole approach to tax incentives — one of rather careless or loose analysis, failure to recognize that dollars are being spent, or recognize the defects inherent in working within the constraints of the positive tax system" (p. 140) should weigh heavily against the use of tax subsidies. And yet it does not seem that change can be accomplished without political recognition that these matters should be resolved by the substantive congressional committees rather than the tax committees.

In spite of the new approach reflected in the method described in Professor Surrey's book, it is discouraging to see that the tax expenditure analysis has not deterred legislators and special interests from still turning automatically to tax benefits as the principal device for coping with economic problems. Bills are continually introduced to change the tax laws to take care of problems like pollution control, retirement income, and others. Perhaps the heightened understanding of tax benefits produced by Professor Surrey's book will stimulate resistance to more of these proposals than in the past, but there is still not sufficient consensus that the tax law should be purged and the legislative process revised to make substantial inroads in these directions.

In future Congresses, a drive for tax simplification may aid this momentum for change. These proponents may be joined by forces seeking lower and less progressive rates. Reform might then result from a combination of groups who seek changes to benefit some general interest, rather than solely from groups seeking to eliminate benefits for the various special interests.

RECENT PUBLICATIONS

THE VICTIMS. By *Frank G. Carrington,* New Rochelle, N.Y.: Arlington House Publishers, 1975. Pp. 295, appendix, index. $9.95 cloth.

Mr. Carrington's thesis is that the rights of crime victims in America have been disregarded and subordinated to the rights of the lawless and violent. The perpetrators of this situation are the architects of the present criminal justice system: the courts, sociologists, and political liberals. The resulting system, he argues, is an elaborate thicket of contrived protections shielding the accused without regard for the plight of the crime victims.

Mr. Carrington, a lawyer and criminologist, proposes the establishment of a Victims' Rights Commission whose purpose would be, *inter alia,* to support proper and responsible law enforcement and to make recommendations for reform of the criminal justice system. He recommends the development of systems for compensating the crime victims. While no hard legislative program is presented, the book is filled with suggestions.

THE CASE AGAINST DIRECT ELECTION OF THE PRESIDENT: A DEFENSE OF THE ELECTORAL COLLEGE. By *Judith Best,* Ithaca, N.Y.: Cornell University Press, 1975. Pp. 218, bibliography, index. $9.95 cloth.

The issue of how to choose a President has been controversial for nearly 200 years. Professor Best bases her argument in favor of the continued use of the electoral college system on a curious mix of historical, political, and statistical data. She readily admits the defects of the present system but argues forcefully that the proposed replacements are no better.

SAVING THE COAST: CALIFORNIA'S EXPERIMENT IN INTERGOVERNMENTAL LAND USE CONTROL. By *Melvin B. Mogulof,* Lexington, MA: Lexington Books, 1975. Pp. 106, appendices, bibliography. $12.00 cloth.

Saving the Coast details the political and environmental repercussions of the California Coastal Zone Conservation Act of 1972. The purpose of the work is to present to the nation's other coastal states the processes, successes, and mistakes encountered in California regarding its comprehensive coastal zone management program. The author examines in detail the interrelationships of the multi-leveled governmental structure — federal, state, regional, metropolitan, county, and city — in the implementation of coastal zone management. The appendices will be of special interest to legislators and others seeking to implement land control legislation at the state level.

A THEORY OF PUBLIC BUREAUCRACY: POLITICS, PERSONALITY, AND ORGANIZATION IN THE STATE DEPARTMENT. By *Donald P. Warwick*, Cambridge, MA: Harvard University Press, 1975. Pp. xii, 215, appendix, bibliography, index. $12.00 cloth.

Designed for the general reader rather than the sociologist, *A Theory of Public Bureaucracy* focuses on the sources of bureaucratic growth and persistence in the United States State Department. Unfortunately, because of the unique subject matter and the research materials employed, extrapolations to other agencies may be both misleading and unhelpful. The study was designed to incorporate the disciplines of sociology, social psychology, and public administration, but without the scientific sensitivity of machine tabulated questionnaire responses. As a result, the importance of the theories and interpretations advanced by the author suffer.

A PRESIDENTIAL NATION. By *Joseph A. Califano*, New York: W. W. Norton & Co., Inc., 1975. Pp. 327, index. $9.95 cloth.

The rise of the "Imperial Presidency" is once again the subject of anecdotal analysis by an insider who has witnessed firsthand both the unprecedented growth of power and its many misuses. The question presented by Mr. Califano is whether this growth has deformed or enhanced our political system of supposed checks and balances. His answer is equivocal. While Califano admits the need for a strong presidency to guide the nation through troubled political and economic times, he emphasizes the need to place these powers in a healthy democratic perspective by rendering their exercise accountable, responsive, and credible. A final chapter entitled "The Future Presidency" suggests some means to achieve these ends.

MANAGEMENT OF INDUSTRIAL PARTICULATES: CORPORATE, GOVERNMENT, CITIZEN ACTION. By *Joseph M. Heikoff*, Ann Arbor, MI: Ann Arbor Science Publishers, Inc., 1975. Pp. ix, 148, appendices, index.

This book is an interesting look into the history and politics of pollution control in the United States. Dr. Heikoff brings his years of experience as a planner and administrator to bear on the practical problems associated with cleaning up industrially-produced air pollution. The appendices make this a valuable book with which to begin an examination of the problem of clean air management.

CONGRESSIONAL ETHICS: THE VIEW FROM THE HOUSE. By *Edmund Beard & Stephen Horn*, Washington, D.C.: The Brookings Institution, 1975. Pp. 83, index. No price listed.

This work concentrates on how members of the United States House of Representatives perceive the ethical issues — personal financial investments; receiving money, goods, or services from outside sources; assisting private parties dealing with the government; and lobbying by ex-congressmen — facing them during the relatively quiet period immediately before the Nixon-Agnew administrations. The methods used were two: first, a questionnaire consisting of forty-four hypothetical situations were posited to a random sample of 50 congressmen; second, back-up interviews were given to obtain more in-depth responses. While the methodology is interesting, the approach scholarly, and the analysis on point, the work suffers from the fact that the reform minded post-93rd Congresses simply are not the surveyed 90th Congress.

PRESIDENTIAL SPENDING POWER. By *Louis Fisher*, Princeton, N.J.: Princeton University Press, 1975. Pp. 266, table of cases, index. $12.50 cloth, $3.45 paper.

The power to raise and spend monies for the national benefit — the so-called power of the purse — in theory resides with the Congress. Mr. Fisher, in a highly documented analysis, pinpoints the fallacy of this belief in light of both the increasing power of the Executive and Administrative bodies to block or divert funds allocated by Congress from reaching their goal and the frequency with which the Executive is able to locate funds for projects not approved by Congress. The examples cited include the millions used to finance the Cambodian incursion and the impoundment actions of the Nixon Administration. The author concludes that Congress should recapture the power to allocate and spend usurped by the Executive and nonelected, nonrepresentative administrators and political appointees.