LEGISLATION

THE SECURITIES EXCHANGE ACT OF 1934—The economic chaos of the past five years has again focused public attention on the stock exchanges, their practices and place in the national economy. The Senate Committee on Banking and Currency[1] has revealed practices inimical to the national welfare: share transactions by officers and directors of corporations beneficial to those participating, but harmful to the shareholders; pool and other market operations working to the disadvantage of the private shareholder; abuse of positions of trust by officials high in financial circles; and encouragement, by high pressure salesmanship, of senseless speculation by the public. Such revelations have shown that those markets left to self-regulation[2] have not adequately fulfilled their requisite functions, which are (1) to furnish a place where surplus income may be absorbed by business associations and governmental agencies; (2) to provide a place where securities may be readily converted into cash; and (3) to provide the economic machinery whereby values may be placed on securities.[3] To secure these ends, Congress has enacted the Securities Exchange Act of 1934.[4] At this time, only the scope of possible regulation and the problems most likely to come before the courts may be indicated.

Constitutionality[5]

Since the Act contains a typical saving clause,[6] to the effect that if any part of the Act, or its application to any person is invalid, this shall have no effect on the remainder, opponents of the Act will be faced with the task of invalidating each provision on its own merits. For this reason, an effective analysis of the constitutionality of the Act must be more extended and detailed than it otherwise would.

Congress clearly sets forth in the Act the grants of power upon which federal regulation is predicated:[7] the power of Congress to regulate commerce among the several states, to control the postal system, to establish and regulate a banking system, and to levy and collect taxes. None of these grants directly gives Congress power to regulate stock exchanges, but it is claimed that the

1. *Hearings before Committee on Banking and Currency on S. Res. 84, 56, 97, 239*, 73d Cong., 1st Sess. (1933).

2. For methods of regulation prior to this Act see HUEBNER, STOCK MARKET (1922) 110.

3. STOCK MARKET CONTROL (Twentieth Century Fund, Inc. 1934) 13; HUEBNER, *op. cit. supra* note 2 at 31; Report to Secretary of Commerce of Committee on Stock Exchange Regulation, 73d Cong., 2d Sess. (1934) 5.

4. P. L. No. 291, 73d Cong., 2d Sess. (1934).

5. For a more complete discussion of this problem see DESVERNINE, MCGARVEY, AND HUTTO, THE EXTENT OF FEDERAL POWER TO REGULATE STOCK EXCHANGES AND STOCK EXCHANGE FIRMS (1933); *Hearings before the Committee on Banking and Currency on S. Res. 84*, 73d Cong., 1st Sess. (1934) (brief by Thomas B. Gay) 6647; *Hearings before Committee on Interstate and Foreign Commerce on H. R. 7852*, 73d Cong., 1st Sess. (1934) 917 (brief by Noel T. Dowling); *ibid.* at 925 (brief by T. G. Corcoran and B. V. Cohen); Hanna, *The Federal Regulation of Stock Exchanges* (1932) 5 So. CALIF. L. REV. 9.

6. Securities Exchange Act § 33.

7. "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions." *Id.* § 2.

"necessary and proper" clause, considered in connection with these grants, gives Congress implied power to regulate the exchanges.

Congress relies mainly on its powers in connection with the regulation of interstate commerce, to sustain the validity of the Act. In determining the constitutionality of legislation under the commerce clause, particular regard must be had to the nature of the business to be regulated. A stock exchange, being essentially a market place, does not deal in securities, but only furnishes the facilities whereby purchases and sales may more readily be completed by its members. As the contract of sale is made on the floor of the exchange, and is completed by delivery of the security through a subsidiary of the exchange, or directly between the members, the transaction is essentially a local one. However, the order to the broker to buy or sell a security, or the security itself, may originate in a state other than the one in which the exchange is located. In this connection, three types of transactions must be noted: (1) where the buyer, the seller, and the exchange are all in the same state; (2) where the customer is in a state other than the state of the broker and the exchange, and the security is forwarded to, or sent by, the customer, according as he is buyer or seller; and (3) where the customer is in a state other than the broker and the exchange, but no securities are forwarded, they being held by the broker and sold either on order of the customer, or for insufficient margin. These classes vary considerably in their effect on interstate commerce, and so may receive different treatment from the courts. Admitting the power to regulate transactions in classes (2) and (3), the court might nevertheless find difficulty in regulating class (1). Two analogies are open to the court. On the one hand are decisions like the *Shreveport* case,[8] in which the power to regulate purely intrastate transactions was predicated on the impossibility of effective regulation of interstate transactions alone. On the other hand are decisions like the *Employers Liability Cases*,[9] which held that where separate treatment of intrastate and interstate transactions was feasible, the former cannot be regulated by the federal government. The choice will probably depend upon a statistical analysis of exchange transactions.

The judicial interpretation of the Congressional power over interstate commerce is no narrow technical doctrine. Under it, the Court may well hold that securities are articles of commerce, a question the Court has expressly left open.[10] Securities are generally considered as property, and are bought and sold and taxed as such. It has been suggested that the line of cases starting with *Paul v. Virginia*,[11] holding certain activities of insurance companies subject to state regulation, is analogous. Such cases proceed on the basis that insurance contracts are of a "personal" nature and are not the subject of sale and barter. Having neither of these attributes, a case involving securities can easily be distinguished. Moreover state, not federal regulation was involved in all of these cases.

Board of Trade v. Olsen[12] is the leading case on the power of Congress to regulate exchanges. This case held that a federal statute regulating transactions in grain futures on the Chicago Board of Trade was constitutional, under the power to regulate commerce. In the opinion, considerable emphasis was placed on the effect which trading in grain futures had on the huge volume

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8. Houston, East and West Texas Ry. v. United States, 234 U. S. 342 (1914).

9. 207 U. S. 463 (1908).

10. Hall v. Geiger Jones, 242 U. S. 539, 558 (1916). But see Alabama & N. A. Trans. Co. v. Doyle, 210 Fed. 173, 182 (E. D. Mich. 1914); Bracey v. Darst, 218 Fed. 482, 495 (D. W. Va. 1914).

11. 8 Wall. 168 (U. S. 1868). A Senate Judiciary Committee reported that insurance was not a subject of regulation as commerce, SEN. REP. No. 4406, 59th Cong., 1st. Sess. (1907).

12. 262 U. S. 1 (1923).

of grain which was shipped each year, from the west to the east, and abroad, with Chicago acting as the neck of the bottle. The reasoning of this case can well be applied to the regulation of securities exchanges, the transactions on the exchanges having considerable effect on the interstate shipment of securities. The difficulty, however, is whether the comparatively small bulk of securities shipped can be compared with the thousands of carloads of grain shipped each year.

Even if securities are held not to be articles of commerce, the Act may still be held valid under the theory of the Court in *Board of Trade v. Olsen.* The transactions in securities do indirectly have a considerable effect on shipments of *other* goods, and the rule of the above case may be extended to situations where the transactions affect important interstate shipments of such other goods.

No express limitation exists to restrict the power of Congress over the mails, whether intrastate or interstate, and this power has been broadly exercised.[13] Such power must not, however, be exercised so as to interfere with "rights reserved to the people of far greater importance than transportation of the mail".[14] Congress has generally used this power to control acts which were generally recognized as more serious wrongs, such as attempts to defraud, and the operation of lotteries. Congress has, however, gone beyond this power and has been sustained by the courts in requiring newspapers to publish lists of their owners.[15] The inference to be drawn from these cases seems to be, that Congress may declare certain acts contrary to the general welfare, and prohibit the use of the mails to those engaged in such transactions. Justice Brandeis approves of this method of regulation.[16] But as a general doctrine it appears too broad. Although, as a practical matter, only a very small part of the business of the country could be carried on without the use of the mails, the Supreme Court is not likely to reach this extreme conclusion that Congress may regulate all business. However, as is very often the case in public law, there does not appear to be any logical point at which the line of limitation should be drawn. Control of over-the-counter markets is rested largely on this power of Congress.[17] While regulation of these markets will probably be upheld by the courts, it may well be doubted that such control will be effective, due to the fact that they are heterogeneous organizations spread all over the country.

The taxing power does not appear to give Congress power under this Act, to regulate the stock exchanges. In the first place, it is not a taxation statute, the only fee required being that for the registration of exchanges. Second, the Supreme Court has expressly stated that Congress may not use its taxing power to regulate matters which it cannot otherwise control.[18] Whether Congress may under its powers to create and maintain a currency, regulate the stock exchanges, because of the effect which the transactions on the exchanges have on government credit, is a question on which there is no authority. All previous legislation under this power has been directed to banks and bankers, the influence of whose activities on national credit is, of course, very direct. That the great securities markets, too, exert a direct influence on the credit of the government and its fiscal system is not open to doubt. It is in these markets that the government borrows money and has its securities quoted daily; and

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13. *Ex parte* Jackson, 96 U. S. 727 (1877); *In re* Rapier, 143 U. S. 110 (1892); Warren v. United States, 183 Fed. 718 (C. C. A. 8th, 1910); Rogers, *The Postal Power of Congress,* Johns Hopkins University Studies in Social and Political Science, ser. 34, No. 2, 158 *et seq.*

14. *Ex parte* Jackson, 96 U. S. 727, 732 (1877).

15. Lewis Publishing Co. v. Morgan, 229 U. S. 288 (1913).

16. OTHER PEOPLE'S MONEY (1914) 88.

17. § 15 of the Act.

18. Bailey v. Drexel Furniture Co., 259 U. S. 20 (1922).

for taxation purposes the prices quoted serve as a basis, giving the government a direct interest in seeing that the quotations reflect true value. Thus the power exists for the regulation of lending and borrowing by brokers and dealers.

It has been suggested that regardless of technical concepts, the court may find, on the basis of economic research, that stock exchanges, and especially the New York Stock Exchange, are national institutions to be governed by national law. The New York Stock Exchange presents problems involving the national welfare that cannot be adequately dealt with by any state or group of states.[19] However, such power to regulate a national institution should come through a constitutional amendment.

Manipulative Practices

In order that the quoted value might more nearly equal the investment or true value of securities,[20] certain practices affecting price, and serving no useful economic function, have been prohibited by the Act. Other activities whose economic utility is doubtful are permitted under rules and regulations of the Commission. Until there are court decisions deciding whether this or that particular transaction is prohibited by the Act, it will be impossible to state the exact scope of Sections 9 and 10: but the general nature of the transactions sought to be regulated may be pointed out. Three types of transactions have been prohibited. (1) Any series of transactions in which the price of the security is affected, or an appearance of market activity created for the purpose of inducing purchases or sales by others. When a trade is for a direct profit, and when to bring others into the market, is difficult of determination. Every market transaction to some extent induces sales and purchases by others; but it may be said generally that this section would not apply unless there was a deliberate attempt at market manipulation.[21] (2) Circulation of information in the course of business, by a broker, dealer, seller, or buyer, or anyone who receives a consideration from such person, concerning pool operations, even if the information is true. This is mainly directed against the activities of customers' men and tipster sheets. A statement at the club or at home is not within this prohibition, although such a statement may, of course, be equally effective in inducing market action. (3) False or misleading statements of a material matter by brokers, dealers, sellers, or buyers, which they had reason to believe were false or misleading, and which were made for the purpose of inducing the purchase or sale of securities.

Other activities which may serve some useful economic function, but which may also be used to create false values, are permitted, under rules and regulations of the Commission. Among these are: (a) a transaction to peg, fix, or stabilize prices; (b) dealing in puts, calls, straddles, and other options; (c) short sales; (d) stop loss orders; (e) other manipulative or deceptive devices. These provisions apply to members of exchanges in all cases, and to all other persons, if the transaction is conducted on an exchange, or use is made of the mails or any instrumentality of interstate commerce. The courts will certainly experience difficulty in distinguishing between certain of the prohibited activities and those which are to be regulated.

To prevent exchange members from having an advantage over the general public by being on the floor of the exchange, the commission may regulate

19. For an elaboration of this view see Isaacs, *The Securities Act and the Constitution* (1933) 43 YALE L. J. 218.

20. Though doubt has been expressed as to whether securities have an "investment value", it will be assumed that the term may be defined as "a function of córporate earnings indicated at any moment of time by all the relevant facts available to appraisers at that time". Note (1934) 34 COL. L. REV. 500 n. 3.

21. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 (1934) 73; SEN. REP. No. 792, 73d Cong., 2d Sess. (1934) 17.

or prohibit trading on the floor of the exchange by members for their own or discretionary accounts.[22] However, the commission may only regulate, and not prohibit, trading by members for their own account through other brokers, and has no control over such trading for discretionary accounts. The function of the odd-lot dealer was thought economically and socially desirable, to allow "the little fellow" to purchase securities. An odd-lot dealer may buy and sell only such securities for his own account as are reasonably necessary to carry on his business, another restriction which a court of law may find difficult to apply. To prevent abuses, such dealers are required to be registered with the Commission. These provisions are in furtherance of the policy of segregation of the activities of the members of the stock exchanges.

Much attention was focused by the Senate Committee on Banking and Currency on the specialist and his function of keeping the market liquid. It was alleged that, from a knowledge of his "book", the specialist could predict the trend of the market, and by dealing on his own account make substantial profits. Also, some specialists had become allied with pool operators, and used their position to take unfair advantage of the investor, by showing their books to the pool operators, enabling them to see the amount of buy and sell orders which were in the market.[23] As to market liquidity, it is a question whether close quotations from hour to hour, subject to abuse, are socially preferable to a market with wider spreads between the bids and offers, but not subject to the abuses alleged to be attached to the activities of some specialists. The specialist must be registered, and the Commission may prohibit or limit his activities as a dealer.[24] If allowed to act as a dealer, his transactions are to be limited to those reasonably necessary for the maintenance of a fair and orderly market. Two other limitations are placed on his activities: (1) The specialist may not open his "book" to anyone, unless it is open to all members of the exchange; the Commission also has authority to require his "book" to be open to all members under such rules and regulations as will be in the public interest and protect investors. (2) The specialist may not execute discretionary orders, but may only effect market or limited price orders. This apparently does not prohibit stop loss orders, as such orders are conditional market orders rather than discretionary orders.[25]

No man can serve two masters. This maxim is the basis of the criticism of the practice of an individual's acting both as broker and dealer. Worthless securities were doubtless unloaded due to this dual relationship.[26] Under the Act, two important restrictions in this respect are placed upon brokers. (1) No broker may carry, or "arrange for" the carrying on margin of part of a new issue in which he participated, within six months from the time of participation in such issue. (2) The broker must inform the customer in writing, at or before the completion of the transaction, whether he is acting as dealer or for his own account.[27] Under the wording of the statute the time when notice is to be given is important—"at or before the completion of the transaction". Where a broker-dealer executes an order for such security, the transaction apparently is complete when the order is executed, confirmation being no part of the transaction. Therefore it has been suggested that the broker-dealer send a general

22. Discretionary accounts give the broker authority to buy and sell securities for the account, whenever in his judgment such action is advisable.

23. *Hearings, supra* note 1, *S. Res. 84*, Parts 13, 14.

24. § 11 (b) (2), 11 (c) of the Act.

25. A stop loss order is an order to sell the security immediately, at the market, upon the security declining to a designated price. A discretionary order is an order to buy or sell whenever the broker or specialist believes it advisable to do so.

26. SEN. REP. No. 792, 73d Cong., 2d Sess. (1934) 11.

27. § 11 (d) of the Act.

written notice to all customers that unless specific notice is given, he is acting as broker in subsequent transactions.[28]

To prevent unfair use of information gained by directors, officers, and large shareholders, every director, officer, and owner of ten *per cent.* of any class of any "equity security",[29] must file a statement with the exchange and the Commission of all his holdings in the corporation, at the time of registration of such security or within ten days after he becomes such director, officer, or shareholder.[30] This section applies only to "equity securities", which are shares, convertible bonds, and bonds with stock purchase warrants. If in any month any change is made in the shares held by such person, a report of such change must be filed.[31] A further limitation is placed on the activities of such shareholder, director, or officer,[32] in that they may not sell securities of their corporation short, nor sell them "against the box",[33] nor on credit. The latter two are prohibited by a provision that it is unlawful for such person to sell securities unless he delivers the securities to his broker within twenty days, or places them in the mails or other instrumentality of interstate commerce, within five days.

As a check on the growing tendency toward the divorce of ownership from management, *no person* may, by the use of the mails or any instrument of interstate commerce or the facilities of any national security exchange, solicit proxies, and no broker may give proxies for his customers' securities, except under rules laid down by the commission. The attempt to give ownership a more intelligent voice in management is also furthered by requiring very complete financial reports to be filed with the exchange.[34]

It is interesting to compare the provisions regarding manipulation in the Act, and in the existing rules of the New York Stock Exchange. The Exchange rules provide for the expulsion of members who engage in transactions involving no change in ownership.[35] So, under the Exchange rules a member might make transactions for the purpose of manipulating prices, as long as a change in ownership of the securities was effected. The only limitation on this, is a power of suspension over any member, "guilty of any act which may be . . . detrimental to the interest or welfare of the Exchange". Thus, the Act goes much further than the Stock Exchange in regulating manipulation.

Control of Credit

In order to check speculation, control must be had of the fuel for the speculative mania, credit. Prior to 1933, the amount of short term credit was

28. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 (1934) 92. But see Seligman, *Problems under the Securities Exchange Act* (1934) 21 VA. L. REV. 1, 28.

29. § 3 (a) (11) of the Act. "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security, or any such warrant or right; or any security the Commission shall deem to be of similar nature . . ." See also Sec. and Ex. Comm. Release No. 21, Oct. 1, 1934, at 2. For discussion of various fact situations under this section, see Seligman, *supra* note 28.

30. § 16 (a) of the Act.

31. Regulated by the Commission, Sec. and Ex. Comm. Release No. 1, Rule N A 1, Aug. 13, 1934, *as amended* Release No. 9, Rule N A 1, Sept. 18, 1934; *id.* Rule N B 1; *explained* Release No. 21, Oct. 1, 1934.

32. Sec. and Ex. Comm. Release No. 1, Rule A T 2, Aug. 13, 1934. "The term 'officer' means a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers."

33. "Selling against the box" is a technical term for a transaction in which the seller sells shares and allows the broker to carry the transaction as a short sale, although the seller actually owns a similar or larger amount of the same issue, the certificates for which he holds, possibly in his safety deposit box.

34. § 13 of the Act.

35. NEW YORK STOCK EXCHANGE CONST. art. XVII, § 3.

left unregulated, except as it was affected by the rediscount rate of the Federal Reserve Bank. In 1933, by the Glass-Steagall Act,[36] the Federal Reserve Banks in each district were charged with the duty of "ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities." Their power is limited to reporting the facts to the Federal Reserve Board, and the Board may then, in an extreme case, suspend any member bank from the use of credit facilities of the Federal Reserve System.

To control the flow of credit to the stock market, the Act establishes control over broker's borrowings and also of the amount brokers may lend to customers. Brokers may borrow only from member banks in the Federal Reserve System, and from such nonmember banks[37] as sign an agreement to comply with the provisions of the Federal Reserve Act, the Banking Act of 1933, and the provisions of this Act that relate to the use of credit to finance transactions in securities.[38] Further, to meet "emergency" needs, brokers are permitted to borrow from each other or from any lender whatever.[39] However, these restrictions do not apply unless the loans are made "in the ordinary course of business as broker or dealer", or on a registered security; they do not apply to exempted securities. These provisions would not seem to prevent a broker from carrying a credit balance for a customer if such balance was created in good faith on a genuine stockbrokerage account. As a further protection against a broker's insolvency, the Act sets out that a broker's total indebtedness shall not exceed twenty times his net capital, with power in the commission to prescribe a lesser amount.[40]

A further check on borrowing, and an added protection to customers, is involved in the regulation of hypothecation of securities. Under rules and regulations of the Commission a broker cannot (1) commingle securities of a customer, without his written consent, with securities of other customers; (2) commingle securities of a customer, even with the customer's consent, with securities of anyone else except bona fide customers; or (3) subject securities of a customer to a claim or lien in excess of the aggregate indebtedness of the customer.[41]

The most controversial feature of the Act involved the margin requirements, *i. e.*, the amount brokers could loan customers. After much controversy, the whole matter has been left in the hands of the Federal Reserve Board for rules and regulations,[42] although the Act prescribes a norm. The norm states the maximum credit that may be initially extended by a broker or dealer to a customer: either (1) 55 *per cent.* of the current market price, *or* (2) 100 *per cent.* of the lowest market price during the preceding thirty-six months, provided the latter amount is not more than 75 *per cent.* of the current market price. The purpose of this double margin standard is as Meyer points out:[43]

"(1) to permit relatively lower margins on stable securities than on those susceptible of wide fluctuations; and

(2) to permit a relaxation of requirements as security values decline and to impose more stringent ones as they rise."

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36. 48 STAT. 163 (1933), 12 U. S. C. A. § 301 (Supp. 1933).

37. § 8 (a) of the Act; Margin Rules of Fed. Res. Board, Regulation T, Series of 1934 § 11.

38. § 8 (a) of the Act; Margin Rules, *supra* note 37, § 10.

39. § 8 (a) of the Act; Margin Rules, *supra* note 37, § 10 (c).

40. § 8 (b) of the Act.

41. § 8 (c) of the Act; SEN. REP. No. 792, 73d Cong., 2d Sess., Ser. No. 3420 (1934) 11. For law prior to the Act see DOS PASSOS, STOCK BROKERS AND STOCK EXCHANGES (1905) 254; MEYER, THE LAW OF STOCK BROKERS AND STOCK EXCHANGES (1931) 331.

42. § 7 of the Act; Margin Rules, *supra* note 38. Since the margin increases as the price of the security rises, pyramiding on paper profits is made difficult. H. R. REP. No. 1383, 73d Cong., 2d Sess., Ser. No. 9323 (1934) 8.

43. MEYER, SECURITIES EXCHANGE ACT OF 1934 (1934) 53.

The rules and regulations promulgated by the Federal Reserve Board substantially follow this norm.[44] Under such rules and regulations, the amount that may be borrowed on initial purchases of securities whose price is comparatively stable, is greater than the amount allowed under rules of the Stock Exchange (as of Oct. 1, 1934), while the amount allowed on some speculative securities is decidedly less. The number of brokerage accounts which have been closed out since 1929 suggests that the Stock Exchange margin requirements were not as well enforced as they might have been. However, it seems likely that the margin rules under the Act will be strictly observed, in view of the fact that enforcement will be conducted by a government agency with penalty of fine or imprisonment.

Power of the Commission

In order that the Act might be workable, and adaptable to changing conditions and practices in the stock markets, wide rule making power has been delegated to the Commission. In many cases the only restriction on this power is that such rules and regulations be "necessary or appropriate in the public interest and for the protection of investors". Thus, the Commission may exempt any security, exchange or person unconditionally or upon terms set by the Commission, from any or all provisions of the Act. Also, it may make rules and regulations governing certain manipulative practices. It may require a variety of reports from exchanges and corporations in the form it prescribes. The Commission might under this power subject all corporations whose securities are registered, either by being on an exchange or traded in "over-the-counter", to adopt uniform accounting practices. However, it appears that the Commission will not take such a drastic step, and will allow reports to be made on the basis of any sound accounting system.[45]

Perhaps the most far reaching rule-making power is in connection with the "over-the-counter" markets.[46] These markets presented such varied situations and problems that it was thought best to leave their regulation to the Commission rather than to set up in the Act inflexible rules governing them.

The Commission may impose drastic penalties. For violation, by an exchange, of a provision of the Act, or a failure to enforce, in so far as it can, compliance with the rules, the Commission may suspend for a period not exceeding twelve months, or withdraw altogether the registration of an exchange.[47] Such action can be taken only after notice and hearing, and under Section 25 would be subject to review by the courts. Similar penalties may be imposed upon a member of an exchange or an issuer who fails to comply with any provision of the Act.[48] Trading in a particular security may be suspended for a period not exceeding ten days, without notice to the issuer, if in the interest of the public. And with the approval of the President of the United States, the Commission may suspend all trading on any exchange for a period not exceeding ninety days.[49]

To secure compliance with the Act, the Commission may compel alteration of a rule of an exchange in regard to certain subjects.[50] Before making such

44. Margin Rules, *supra* note 37; see articles by A. Stewart in N. Y. Times, Sept. 29, 1934, p. 23 *et seq.*

45. § 13 of the Act; H. R. Rep. No. 1383, 73d Cong., 2d Sess., Ser. No. 9323 (1934) 11; Withington, Securities Exchange Act Analysed (1934) 26.

46. § 15 of the Act.

47. § 19 (a) (1); by section 6 (a) (1), each exchange registered must sign an agreement to comply and to enforce as far as within its powers compliance by its members with the provisions of the Act and every rule and regulation thereunder.

48. § 19 (a) (2) of the Act.

49. § 19 (a) (4) of the Act.

50. § 19 (b) of the Act. The certain subjects include: "(1) safeguards in respect to the financial responsibility of members and adequate provision against the evasion of financial

order, the Commission must request the exchange in writing to make the new rule, and if the exchange fails to do so, the exchange will be given an opportunity for a hearing. Whether the change will be made by a rule or regulation, or by an order of the Commission, is within the discretion of the Commission. This is an important power, as only an order of the Commission is specifically reviewable by the Court.

To aid in enforcement, the Commission is empowered to investigate, proceed by injunction, instigate criminal proceedings, and apply for writs of mandamus.[51] The Commission may make any investigation which it believes necessary to disclose or prevent a violation of the Act, or to serve as a basis for recommending future legislation. In its discretion, the Commission may publish any information it deems necessary concerning a violation of the Act.

Civil Liability

Civil liability[52] is imposed for dissemination of false or misleading statements in the course of business as to market activity; participation in prohibited practices; and for false or misleading statements, though oral, for the purpose of inducing the purchase or sale of a security. For false or misleading statements as to market activity, under Section 9, the Act goes beyond the common law.[53] It allows damages, even though the person to whom the statement was made did not rely on it, and even though the person making it did not know it was false, provided he had reasonable ground to know it was false or misleading. The right to rescind for false representation is not as broad as at common law, as rescission has been allowed at common law for an innocent misrepresentation. This section applies to transactions on exchanges and by exchange members, even though no use is made of the mails, or any instrumentality of interstate commerce, whereas, in The Securities Act of 1933,[54] under Section 12, one of these instrumentalities must be employed. Here the plaintiff has the burden of proof that the defendant had reasonable ground for belief, whereas, under the Securities Act, such burden is on the defendant. Under this Act, relief is limited to damages, whereas under the Securities Act the plaintiff, on tendering back the security, may recover the consideration paid. Suit under this Act may be brought only in the federal courts, while under the Securities Act suit may be brought in either the federal or state courts.

Anyone who wilfully participates in any of the acts prohibited in Section 9, becomes liable to anyone who buys or sells a security at a price which was

responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters."

51. § 21 of the Act.

52. Fine and imprisonment are provided for a wilful violation of the Act, § 32 of the Act.

53. See Berle, *Liability for Stock Market Manipulation* (1931) 31 Col. L. Rev. 264; (1934) 34 Col. L. Rev. 500. Damages allowed in the bill as first drafted were the difference between price plaintiff paid and lowest price on the exchange for a period during ninety days preceding and ninety days following plaintiff's purchase and such additional damages as plaintiff might prove, § 8 (b), S. 2693, *Hearings Before Committee on Banking and Currency on S. Res. 84*, 73d Cong., 1st Sess. (1933) 6427; discussed at 6518.

54. P. L. No. 22, 73d Cong., 1st Sess. (1933); see Shulman, *Civil Liability and the Securities Act* (1933) 43 Yale L. J. 227; Legis. (1934) 48 Harv. L. Rev. 107.

affected by such act. Thus there need be no connection between the plaintiff and defendant, except that the plaintiff be a bona fide buyer or seller in the market which has been subjected to the effects of a prohibited practice. The plaintiff would have to prove only that the act done was prohibited, that defendant intended to do the act, and that plaintiff bought or sold. Damages allowed are "those sustained as a result of such act or transaction". Probably this would be the difference between actual value and the price paid, actual value being determined by consideration of market value, earning power, management of the corporation, its history, *etc.*[55]

For a false or misleading statement as to a material fact in any document filed under the Act, anyone who buys or sells a security at a price which was affected by the statement, and who relied thereon, may recover damages.[56] However, the defendant may escape liability if he can show that he acted in good faith, and had no knowledge that such statement was false or misleading. *Quære* whether liability would attach if defendant knew facts from which a reasonable man would conclude that his statement was false or misleading?

To prevent directors, officers, and large shareholders from using information gained in that capacity to the disadvantage of other shareholders, the Act prescribes that the corporation may recover any profit made by such person from trading in any equity security of the corporation, providing less than six months elapse between the purchase and sale.[57] If the corporation refuses to bring an action for these profits, any shareholder may bring the action for the benefit of the corporation. This right is not dependent on the intent of such person in acquiring or selling the security. Whether he intended to hold the security for more than six months, or, if a sale, intended not to reacquire it, is immaterial. This is one of the most striking provisions of the Act, and if not circumvented by the use of corporate intermediaries, will result in a salutary disruption of the present close relationship between a large number of corporate officials and heavy shareholders, and the stock market.

In any situation where several persons are liable under this section, and one person is sued separately, he may compel contribution from the other persons so liable. Further, any person who "controls", directly or indirectly, any person liable under any provision of the Act is liable to the same extent as the controlled person.[58] Control, it would seem, includes actual as well as legally enforceable control. However, the controlling person may escape liability if he acted in good faith and did not directly or indirectly induce the act constituting the violation or the cause of action. Any civil liability under the Act is in addition to those already existing at law or equity, but no one may recover more than his actual damages.[59]

Invalidity of Contract

No section of the Act will provide a more fertile source of litigation than Section 29, concerning the validity of contracts. Any provision in a contract binding any person to waive compliance with any provision of the Act or any rule of an exchange is void. Thus, unless the whole contract were not contrary to a provision of the Act, it would serve as a basis of legal rights and duties, although the waiver would be invalid. Contracts which violate the Act are declared "void" in their entirety, without further particularization of the legal consequences. It is probable, however, that an innocent person could enforce

55. MEYER, SECURITIES EXCHANGE ACT OF 1934 (1934) 81.
56. § 18 of the Act.
57. § 16 of the Act. By Release No. 9, Rule N B 1, a purchase before Oct. 1, 1934, followed by a sale after that date, but within six months of the purchase or sale, followed by a purchase, is exempt from this provision.
58. § 20 of the Act.
59. § 28 (a) of the Act.

such a contract, and legal process would be denied only to the person on whom the duty or prohibition is placed by the Act.[60]

More difficult questions will be presented to the courts in connection with contracts which were lawful before the Act, but whose performance may later be in contravention of some rule or regulation of the Commission. For example, are proxies valid which were solicited before the passage of the Act, in a manner later to be declared unlawful by the Commission? And if invalid, what is the effect on corporate action taken at a meeting where such proxies were voted? These and many other questions await judicial definition of the consequences of a "void" contract.

Two classes of contracts, although made in violation of the terms of the Act, are expressly exempted from being "void": (1) a loan or extension of credit, or lien created, where the lender does not have actual knowledge of the facts constituting the violation, and (2) a debt or obligation acquired by a person other than a party to the contract, in good faith and for value, and without actual knowledge of the violation.

Conclusion

By legislation Congress has attempted to determine what is legitimate speculation and what is gambling,[61] and to lessen speculation by those persons not financially qualified to engage in it. None of the sections of the Act should impose undue burdens on corporations whose securities are offered for sale on the exchanges or in the over-the-counter markets. The reports required, while more frequent and of greater detail than those required by the New York Stock Exchange, are socially and economically desirable. The prohibition of certain market practices and the regulation of others should tend, without economic loss, to make market quotations more nearly reflect the actual value of the securities. Margin requirements should lessen "shoestring" speculation. On the basis of the entire Act no issuer should hesitate to register securities about which the truth has been told. In the last analysis, no legislation is better than the manner in which it is administered. The methods thus far pursued by the Securities Exchange Commission and the Federal Reserve Board give every indication that the Act will work, not to the detriment of brokers and exchanges but to bring that return of confidence to the security markets so necessary for national economic recovery.

K. W. G.

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60. § 29 (b) of the Act; MEYER, *op. cit. supra* note 21, 145.

61. For elaboration that the difficulty is incapable of solution, see Hughes Report quoted in VAN ANTWERP, THE STOCK EXCHANGE FROM WITHIN (1913) 415.