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ADMINISTRATIVE LAW - INVESTIGATING POWERS OF FEDERAL COMMISSIONERS - SECURITIES AND EXCHANGE COMMISSION

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COMMENTS

ADMINISTRATIVE LAW — INVESTIGATING POWERS OF FEDERAL COMMISSIONERS — SECURITIES AND EXCHANGE COMMISSION — A recent decision in the Circuit Court of Appeals¹ upholding the constitutionality of the powers of search granted to the Securities and Exchange Commission in the Securities Act of 1933² brings to the fore again the question of the extent to which the Federal Government may validly investigate and demand the production of the books and records of private businesses.

These compulsory inquisitorial powers have been regarded as an attribute of and dependent on the federal power to regulate business. The principles which may be said to be clearly established by the courts on this subject may be summarized as follows:

- I. If an investigation is undertaken beyond the bounds set by

¹ *Newfield v. Ryan*, (C. C. A. 5th, 1937) 91 F. (2d) 700, cert. denied (U. S. 1937) 58 S. Ct. 54, petition for rehearing denied, 58 S. Ct. 137, 262.

² 48 Stat. L. 74, §§ 1-26 (1933), 15 U. S. C., §§ 77a-77aa (1935).

the enabling statute it is void.³

2. Assuming a proper statute, the constitutional power to regulate a business depends upon the extent to which the business is "affected with a public interest."⁴

3. Only in the aspects in which they are affected with a public interest can such businesses be regulated.⁵

4. Only in the aspects in which they are actually being regulated may such businesses be investigated.⁶

5. Businesses which are being completely regulated, as railroads may be regulated, may be investigated without a complaint or proceeding for violation of the law.⁷

6. On the other hand, businesses which are clearly beyond the pale of plenary regulation cannot be subject to investigation by compulsory processes apart from proceedings in the nature of prosecution for violations of the law.⁸ To do so would be an unconstitutional "fishing expedition," because, the business not being subject to regulation, an investigation would not be in aid of a legitimate object and would therefore be unreasonable.

7. Between the public utilities on the one hand and the purely private business on the other hand, there lies a twilight zone in which the power to use compulsory inquisitorial process in aid of regulation apart from violation proceedings is shrouded in doubt. This twilight zone is primarily involved in this comment.⁹

³ *Harriman v. Interstate Commerce Comm.*, 211 U. S. 407, 29 S. Ct. 115 (1908); *Federal Trade Comm. v. American Tobacco Co.*, 264 U. S. 298, 44 S. Ct. 336 (1924); *Jones v. Securities & Exch. Comm.*, 298 U. S. 1, 56 S. Ct. 654 (1936).

⁴ *Munn v. Illinois*, 94 U. S. 113, 24 L. Ed. 77 (1877); *New State Ice Co. v. Liebmann*, 285 U. S. 262, 52 S. Ct. 371 (1932); *Wolff Packing Co. v. Court of Industrial Relations*, 262 U. S. 522, 43 S. Ct. 630 (1923); *Nebbia v. New York*, 291 U. S. 502, 54 S. Ct. 505 (1934).

⁵ *Wolff Packing Co. v. Court of Industrial Relations*, 262 U. S. 522, 43 S. Ct. 630 (1923). This proposition is also implicit in the holding in *Nebbia v. New York*, 291 U. S. 502, 54 S. Ct. 505 (1934), that the regulation must have a reasonable relation to the end to be attained.

⁶ *Federal Trade Commission v. Smith*, (D. C. N. Y. 1929) 34 F. (2d) 323.

⁷ *Smith v. Interstate Commerce Comm.*, 245 U. S. 33, 38 S. Ct. 30 (1917).

⁸ Although there are no cases so holding, there are dicta to this effect in cases construing statutes so as not to violate the rule.

⁹ No consideration will be given in this comment to the problems of administrative power to investigate in aid of legislation, the degree of definiteness necessary in a demand for information, or the application of the constitutional prohibition against compulsory self-incrimination in investigations by administrative tribunals. For the purposes of the comment all of the inquisitorial powers, the subpoena, subpoena duces tecum, investigations of books and records on the premises, and compulsory reports, have been lumped together since, once the right to this information is established, which of these means is used is merely a question of statute and reasonableness under the

Businesses lying within this twilight zone are not subject to full regulation as are public utilities, nor are they so "private" in nature as to be exempt from all but the most elementary police regulations. They are businesses of considerable public importance, and particularly they are businesses which, if not regulated, will be fraught with possibilities of harm to the public. It is submitted that as to such businesses the Fourth Amendment¹⁰ should not apply to prohibit investigations necessary to reasonable regulation, for, it having been decided that regulation is necessary in the public interest, and knowledge of the facts on which the regulation is based being essential to intelligent regulation, then an investigation to discover these facts should not be "unreasonable."

A recent exposition of this theory is to be found in *Bartlett Frazier Co. v. Hyde*,¹¹ involving the constitutionality of the investigatory powers conferred on the Secretary of Agriculture by the Grain Futures Act. There Circuit Judge Alschuler says:¹²

"Appellants invoke the Fourth Amendment as a shield against the requirement that they subject their books and records to the inspection of the Department, and the making of the reports. The Amendment, which declares the right of the people to be secure in their persons and papers against unreasonable search, cannot be applied to regulations which require reports and disclosures in respect to a business which is affected with a public interest, so far as such disclosures may be reasonably necessary for the protection of the public. Were it otherwise, railroads and public utilities generally could not be required to make reports or to subject their records to inspection by agents of the government. . . .

"It is argued that, because under the law inspections may be made and reports required where there is no charge, suggestion or intimation of conduct contrary to the law, the act is unreasonable and void. . . . Assuming that by the declared statutory purpose of preventing corners and speculation in grains the public interest is subserved, the purpose would be seriously embarrassed if the

circumstances. For a discussion of the sanctions available to administrative tribunals to enforce the production of evidence, see note in 51 HARV. L. REV. 312 (1937).

¹⁰ "The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated. . . ." U. S. Constitution, Amendment IV.

¹¹ (C. C. A. 7th, 1933) 65 F. (2d) 350, cert. denied, 290 U. S. 654, 54 S. Ct. 70 (1933).

¹² *Bartlett Frazier Co. v. Hyde*, (C. C. A. 7th, 1933) 65 F. (2d) 350 at 351; 352.

government were powerless to require the information without regard to whether traders such as appellants were suspected of or charged with breaking the law.”

Thus it appears that such investigation is permissible and not prohibited so long as it is indispensable to proper regulation of a business which may be regulated. And the inference is plain that an investigation not necessary to the attainment of this objective would be beyond the pale.

In order to find that such searches are valid it must be shown that they are not unreasonable, and the peg on which administrative powers of investigation are regularly hung is that they are necessary means to a legitimate end.

“Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the Constitution, are constitutional.”¹³

Granting that federal regulation of the business under consideration is a legitimate end within the scope of the Constitution, then powers of investigation which are appropriate and are plainly adapted to that end are constitutional.

Obviously acquaintance with the private papers of a business is not essential to all types of regulation. Clearly, sanitary laws are not of the kind of regulation requiring investigation of the books and records. A meat inspector is quite able to tell whether an animal is diseased without knowing how much the packer paid for it. This is a kind of regulation for which knowledge of the books is not necessary and, under the foregoing analysis, if the power to investigate the books were granted to the inspector it would be unconstitutional. Equally clearly, the example *par excellence* of the type of regulation for which recourse to the records is essential is rate-making, in which the cost of production must be determined.¹⁴ A rate made without a study of the books of the business could be nothing but a wild guess.

It is primarily economic regulation which carries with it the auxiliary power of investigation, for the economic facts and figures are displayed on the books of the business. Rate-making comes within this classification but there are others. Taxation is one.¹⁵ Regulation of exchanges to prevent price manipulation is now held to be another.¹⁶

¹³ Chief Justice Marshall in *McCulloch v. Maryland*, 4 Wheat. (17 U. S.) 316 at 421, 4 L. Ed. 579 (1819).

¹⁴ *Smith v. Interstate Commerce Commission*, 245 U. S. 33, 38 S. Ct. 30 (1917).

¹⁵ *In re International Corporation Co.*, (D. C. N. Y. 1934) 5 F. Supp. 608.

¹⁶ *Bartlett Frazier Co. v. Hyde*, (C. C. A. 7th, 1933) 65 F. (2d) 350.

Up to the present time the Federal Government has not been lavish in conferring investigatory powers on administrative tribunals, apart from proceedings in the nature of litigated cases for violations and threatened violations of the law. The best known and most pertinent examples of such powers are those given to the Interstate Commerce Commission,¹⁷ the Federal Trade Commission,¹⁸ the Secretary of Agriculture under the Grain Futures Act,¹⁹ and the Securities and Exchange Commission.²⁰ Because of the different types of business and the different kinds of regulation involved, each presents a distinct problem. In the light of the preceding analysis of the problem, let us examine briefly the first three.

I.

The Interstate Commerce Act grants sweeping powers of investigation of the records of railroads and interstate common carriers to the Interstate Commerce Commission.²¹ Although this act applies only to common carriers, which are traditionally subject to regulation,²² and only to interstate carriers, which are clearly within the power of Congress to regulate under the commerce clause of the Constitution,²³

¹⁷ 24 Stat. L. 379, §§ 12, 20 (1887); 49 U. S. C., §§ 12, 20 (5) (1935).

¹⁸ 38 Stat. L. 717, §§ 6, 9 (1914); 15 U. S. C., §§ 46, 49 (1935).

¹⁹ 42 Stat. L. 998, §§ 5, 6 (b), 8 (1922); 7 U. S. C., §§ 7, 15, 12 (1935).

²⁰ 48 Stat. L. 74, §§ 8, 19 (1933), 48 Stat. L. 881, §§ 13, 17, 21 (1934); 15 U. S. C., §§ 77h (e), 77s, 78m, 78v, 78u (1935).

²¹ "The commission created shall have authority to inquire into the management of the business of all common carriers subject to the provisions of this chapter, and shall keep itself informed as to the manner and method in which the same is conducted, and shall have the right to obtain from such common carriers, full and complete information necessary to enable the commission to perform the duties and carry out the objects for which it was created . . . and for the purposes of this chapter the commission shall have power to require, by subpoena, the attendance and testimony of witnesses and the production of all books, papers, tariffs, contracts, agreements, and documents relating to any matter under investigation." 49 U. S. C., § 12 (1935).

"The commission is authorized to require annual reports from all common carriers subject to the provisions of this chapter, and from the owners of all railroads engaged in interstate commerce as defined in this chapter, to prescribe the manner in which such reports shall be made, and to require from such carriers specific answers to all questions upon which the commission may need information." 49 U. S. C., § 20 (1) (1935).

"The commission shall at all times have access to all accounts, records, and memoranda, including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by carriers subject to this chapter . . . and it may employ special agents or examiners, who shall have authority under the order at the commission to inspect and examine any and all accounts, records, and memoranda. . . ." 49 U. S. C., § 20 (5) (1935).

²² *Interstate Commerce Commission v. Baltimore & Ohio R. R.*, 145 U. S. 263 at 275, 12 S. Ct. 844 (1892).

²³ U. S. Const., Art. I, § 8: "The Congress shall have power . . . to regulate

it was not at first completely clear that all of the financial affairs of the railroads were open to investigation by the commission,²⁴ even though the powers were granted in aid of the power to regulate rates which, as pointed out above, is peculiarly a field where knowledge of the financial condition of the company is essential to intelligent action by the commission. In a later case,²⁵ however, following an amendment of the statute, the Supreme Court held that the commission could investigate the private financial affairs of a railroad without a complaint of violation of the act, as such an investigation was within the power of the commission under the statute and was necessary to regulation. Since that decision the railroads have been goldfish to all intents and purposes, against which fishing expeditions, to strain the metaphor, can be directed at any time by the commission on its own motion without the formality of a complaint. But it must be remembered that this is a business clearly subject to plenary regulation, that adequate powers of regulation have been conferred, and that the powers of investigation are given in aid of a kind of regulation which would be ineffective without them.

The compulsory inquisitorial powers of the Federal Trade Commission present a very different picture, although the wording of the statute granting them does not differ materially from that of the Interstate Commerce Act. The Federal Trade Commission Act and the Clayton Act prohibit certain specific practices by businesses which have always been considered as private and not subject to regulation. The act confers on the Federal Trade Commission the power of enforcing these prohibitions and provides that "for the purposes of" the act the commission shall have power to investigate the records of the company.²⁶

Commerce with foreign Nations, and among the several States and with Indian Tribes."

²⁴ *Harriman v. Interstate Commerce Comm.*, 211 U. S. 407, 29 S. Ct. 115 (1908).

²⁵ *Smith v. Interstate Commerce Comm.*, 245 U. S. 33, 38 S. Ct. 30 (1917).

²⁶ "The commission shall also have power—(a) To gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers subject to the Act to regulate commerce, and its relation to other corporations and to individuals, associations, and partnerships. (b) To require, by general or special orders, corporations engaged in commerce . . . or any class of them, or any of them, respectively, to file with the commission in such form as the commission may prescribe, annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective corporations filing such reports or answers in writing. . . . (d) Upon the direction of the President or either House of Congress to investigate and report the facts relating

In many cases these prohibitions are of a type such that their enforcement would be aided by a knowledge of the books of the corporation, as, for instance, the prohibition of intercorporate stockholding which has the effect of substantially reducing competition.²⁷ But the statutes do not seek complete economic regulation of the businesses, only enough to prohibit certain acts by all business. In as much as many of the businesses affected are not of the type traditionally regarded as "affected with a public interest," an attempted plenary regulation would be unconstitutional under the present decisions. Consequently the investigatory powers are not given in aid of an extensive power to regulate, but only to discover and prosecute violations of the specific prohibitions of the statutes. Bearing these factors in mind, it may be readily seen why the interpretation of the investigatory powers granted to the Federal Trade Commission differs so materially from that of the powers of the Interstate Commerce Commission.

A brief review of the principal cases decided under this act will serve to illustrate the point. The best known of these cases is, unquestionably, *Federal Trade Commission v. American Tobacco Co.*,²⁸ which held, by a strict construction of the Federal Trade Commission Act, that an investigation of the private papers of the tobacco company was not authorized by the act in the absence of a proceeding for a violation of the act. The Court rejected the commission's claim of an unlimited right of access to the company's papers. It was in this case that Justice Holmes made his famous statement that,²⁹

"Anyone who respects the spirit as well as the letter of the Fourth Amendment would be loath to believe that Congress intended to authorize one of its subordinate agencies to sweep all our traditions into the fire, and to direct fishing expeditions into private papers on the possibility that they may disclose evidence of crime."

to any alleged violations of the Anti-Trust Acts by any corporation." 15 U. S. C., § 46 (1935).

"For the purposes of this subdivision of this chapter the commission, or its duly authorized agent or agents, shall at all reasonable times have access to, for the purpose of examination, and the right to copy any documentary evidence of any corporation being investigated or proceeded against; and the commission shall have power to require by subpoena the attendance and testimony of witnesses and the production of all such documentary evidence relating to any matter under investigation." 15 U. S. C., § 49 (1935).

²⁷ 15 U. S. C., § 18; price discrimination between purchasers, 15 U. S. C., § 13; sale on agreement not to use goods of competitor, 15 U. S. C., § 14; interlocking directorates, 15 U. S. C., § 19 (1935).

²⁸ 264 U. S. 298, 44 S. Ct. 336 (1924).

²⁹ *Ibid* at p. 305.

There are strong intimations in this case that an attempt by Congress to give the commission this power would be unconstitutional.

The decision in the frequently cited case of *Federal Trade Commission v. Baltimore Grain Co.*,³⁰ is based on similar reasoning, i.e. that the company is a private corporation, not engaged in rendering public service, and as such it cannot be investigated unless it is being proceeded against under the act or unless the investigation is looking toward such proceeding. Applying to these cases the rules set out at the beginning of this comment, it becomes apparent that the holding that these were private businesses not subject to plenary economic regulation is decisive of the cases. Not being subject to such regulation, the power of investigation as used against them, except for a violation of the statute, is not in aid of a legitimate object and is consequently an unreasonable search and seizure.

Another significant case under the Federal Trade Commission Act is *Federal Trade Commission v. Smith*.³¹ In this case demand was made by the commission for information concerning the private affairs of an electric utility holding company which the court assumed to be engaged in interstate commerce. The information sought was not in aid of any proceeding for a violation of the act. In the course of the opinion it is said,³²

"The Congress has not, as yet, undertaken to regulate the interstate carrier of electricity in the same way as interstate common carriers are now supervised and controlled, and the legislative right of the Federal Trade Commission to investigate companies which are engaged in the transmission of electric current over state boundaries . . . is hardly comparable with that of the Interstate Commerce Commission with respect to interstate common carriers.

"Until the powers of petitioner [Federal Trade Commission] with respect to such inquiries as it may undertake shall have been enlarged by appropriate statutes, the present limitations which hedge about its inquisitorial functions must be recognized. . . .

"The company is within the protection afforded by the Fourth Amendment to the Constitution."

In other words, a business may not be investigated until regulation has been undertaken and investigation authorized by statute.

The converse of this situation is illustrated by the powers of investigation given to the Secretary of Agriculture by the Grain Futures Act.

³⁰ (D. C. Md. 1922) 284 F. 886, aff'd. without opinion, 267 U. S. 586, 45 S. Ct. 461 (1925).

³¹ (D. C. N. Y. 1929) 34 F. (2d) 323.

³² *Ibid.* at p. 324.

This act regulates the business of dealing in futures contracts on grain exchanges, which until the passage of the act had been regarded as a purely private business and consequently protected by the Fourth Amendment. Had the Federal Trade Commission attempted to investigate a company engaged in the business, it probably could not have done so except in a proceeding against it for a violation of the Federal Trade Commission Act, as is amply shown by *Federal Trade Commission v. Baltimore Grain Co.*, discussed above. By the Grain Futures Act, however, the business of dealing in grain futures was declared to be one affected with a national public interest³³ and the act provides for the regulation thereof. Such regulation, however, does not go to the extent of regulating rates. The act requires both grain exchanges and their members to keep records of futures transactions in grain, to make reports to the Secretary of Agriculture, and to allow investigations by the Departments of Agriculture or Justice.³⁴ Here, then, is a business previously considered private and not subject to regulation now declared to be subject to regulation in the public interest. Assuming this to be a valid declaration, the question arises as to the effect

³³ "Transactions in grain involving the sale thereof for future delivery as commonly conducted on boards of trade and known as 'futures' are affected with a national public interest; such transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling grain and by-products thereof in interstate commerce; the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of grain and the products and by-products thereof and to facilitate the movements thereof in interstate commerce; such transactions are utilized by shippers, dealers, millers, and others engaged in handling grain and the products and by-products thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price; that the transactions and prices of grain on such boards of trade are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling grain and products and by-products thereof in interstate commerce, and such fluctuations in prices are an obstruction to and a burden upon interstate commerce in grain and the products and by-products thereof and render regulation imperative for the protection of such commerce and the national public interest therein." 7 U. S. C., § 5 (1935).

³⁴ The Secretary of Agriculture is directed to designate a board of trade as a "contract market" only "when the governing board thereof provides for the making and filing by the board or any member thereof, as the Secretary of Agriculture may direct, of reports in accordance with the rules and regulations, in such manner and form and at such times as may be prescribed by the Secretary of Agriculture, showing the details and terms of all transactions entered into by the board, or the members thereof . . . and when such governing board provides, in accordance with such rules and regulations, for the keeping of a record by the board or the members of the board of trade, as the Secretary of Agriculture may direct, showing the details and terms of all cash and future transactions entered into by them. . . . Such record shall be required to be kept for a period of three years from the date thereof . . . and shall

of such a declaration on the investigatory powers to which the business is subject. The purpose of this regulation is to prevent, not merely discover and punish, manipulation of grain prices through futures contracts. This, too, is a type of regulation for which knowledge of the records of the business is necessary, as pointed out in the quotation from *Bartlett Frazier Co. v. Hyde* at the beginning of this discussion. Only by catching them in their incipiency through an inspection of the accounts of the various traders on the grain exchanges can pools and corners be prevented.³⁵ Having a business which it is in the public interest to regulate, and a type of regulation for which access to the books and records of the business is essential, it does not seem surprising that the constitutionality of the act has been upheld as to boards of trade³⁶ and as to the investigation of the records of brokers and dealers on the exchanges.³⁷

2.

With this background of the bases on which the power of the Federal Government to investigate and require reports from business rests, we turn to an examination of the inquisitorial powers conferred

at all times be open to the inspection of any representative of the United States Department of Agriculture or United States Department of Justice." 7 U. S. C., § 7 (1935).

"For the efficient execution of the provisions of this chapter, and in order to provide information for the use of Congress the Secretary of Agriculture may make such investigations as he may deem necessary to ascertain the facts regarding the operations of boards of trade. . . ." 7 U. S. C., § 12 (1935).

"For the purpose of securing effective enforcement of the provisions of this chapter, the provisions, including penalties, of section 12 of Title 49, Transportation [Interstate Commerce Act], relating to the attendance and testimony of witnesses, the production of documentary evidence, and the immunity of witnesses are made applicable. . . ." 7 U. S. C., § 15 (1935).

The scope of the Grain Futures Act has been extended and dealings on commodity exchanges more strictly regulated by the Commodity Exchange Act of 1936. 49 Stat. L. 1491, § 1 (1936), 7 U. S. C., § 1 (Supp. 1936).

³⁵ "No prudent way has ever been devised to obtain information of speculative activities which did not involve in the first instance the keeping of full and complete records of these transactions. It would obviously hamstring the supervising authority if it did not have power to inspect such records quickly when subversive activities are suspected. By their very nature manipulatory activities are consummated quietly and quickly. If Court process had to be resorted to every time manipulation were suspected, there are numerous ways in which the participants could evade detection. Perhaps responsibility could ultimately be placed and the offenders punished, but the primary object of this legislation is prevention and not punishment. Free and unlimited access to the records of these transactions by the proper authorities is the only means yet devised of detecting subversive activities while they are current." Extract from brief for the Government in Circuit Court of Appeals in *Bartlett Frazier Co. v. Hyde*, (C. C. A. 7th, 1933) 65 F. (2d) 350.

³⁶ *Chicago Board of Trade v. Olsen*, 262 U. S. 1, 43 S. Ct. 470 (1922).

³⁷ *Bartlett Frazier Co. v. Hyde*, (C. C. A. 7th, 1933) 65 F. (2d) 350.

on the Securities and Exchange Commission. In examining this subject, it is necessary to break down the inquiry into two parts, the powers of investigation of stock exchanges, brokers, and traders granted by the Securities Exchange Act, and the powers of investigation of issuers and underwriters granted to the commission by the Securities Act of 1933.

The inquisitorial powers granted by the Securities Exchange Act seem clearly to be valid under the theory and decisions relating to the Grain Futures Act, once it is conceded that the business of securities exchanges is so closely connected with interstate commerce as to be within the power of Congress to govern.³⁸ The act itself sets forth that the business of stock exchanges, and of traders and brokers thereon, is one affected with a national public interest because manipulation of prices thereon causes unreasonable fluctuations in the prices of securities and precipitates, intensifies and prolongs national emergencies.³⁹ Having asserted that this is a business affected with a public interest,⁴⁰ Congress proceeds to lay the foundations for regulation of the business, prohibiting manipulation and manipulative devices,⁴¹ restricting borrowing by brokers,⁴² regulating the use of proxies,⁴³ and conferring on the Securities and Exchange Commission the power to enforce the act and to make investigations and require reports.⁴⁴ Is knowledge

³⁸ See *Chicago Board of Trade v. Olsen*, 262 U. S. 1, 43 S. Ct. 470 (1922), and comment in 32 MICH. L. REV. 811 (1934) on the constitutionality of Securities Act of 1933.

³⁹ "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. . . . (3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities. . . . (4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets. . . ." 15 U. S. C., § 78b (1935).

⁴⁰ Whether or not this is a valid assertion it is not the business of this comment to inquire.

⁴¹ 15 U. S. C., §§ 78i, 78j (1935).

⁴² 15 U. S. C., § 78 h (1935).

⁴³ 15 U. S. C., § 78n (1935).

⁴⁴ "Every issuer of a security registered on a national securities exchange shall file the information, documents, and reports below specified with the exchange (and shall file with the Commission such duplicate originals thereof as the Commission may require). . . . (1) Such information and documents as the Commission may require to keep reasonably current the information and documents filed pursuant to section

of the books and records of the exchanges and brokers necessary to effectuate this regulation? It would seem that unquestionably it is. Without such power the use of manipulative devices, such as wash sales, could clearly be neither detected nor prevented, and the commission would be greatly hindered in its enforcement of the act. Therefore, under circumstances quite like those presented by boards of trade under the Grain Futures Act, having a business fraught with possibilities of harm to the public and a type of regulation which would be ineffective without access to private records, the investigatory powers appear to be valid.

The Securities Act, however, is a new departure in the field of governmental regulation of business. The purpose of this act is, in effect, to regulate every corporation in the country in so far as its issuance of securities not exempted from the operation of the act is concerned. In the exercise of this power to regulate the issuance of securities, broad inquisitorial powers are conferred on the Securities and Exchange Commission, specifically providing that the commission may investigate any issuer, underwriter, or any other person connected with the sale of a security, without a complaint of a violation of the act.⁴⁵

78l of this title. (2) Such annual reports . . . and such quarterly reports, as the Commission may prescribe." 15 U. S. C., § 78m (1935).

"Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 78o of this chapter, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe. . . ." 15 U. S. C., § 78q (Supp. 1936).

"The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this chapter or any rule or regulation thereunder, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized, in its discretion . . . to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in securing information to serve as a basis for recommending further legislation. . . . For the purpose of any such investigation, or any other proceeding under this chapter, any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry." 15 U. S. C., § 78u (1935).

⁴⁵ "For the purpose of all investigations which, in the opinion of the Commission, are necessary and proper for the enforcement of this subchapter, any member of the Commission or any officer or officers designated by it are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production

This power, as we have seen, has been held appropriate with respect to investigations under regulations imposed on businesses affected with a public interest, and yet there is in the Securities Act no recital that the business of security issuers is affected with a public interest and in need of regulation, and as the act applies equally to all corporations wanting to put out new security issues it obviously applies to many which heretofore have been regarded as purely private in character and not subject to regulation. Does it follow that the precedents of the Federal Trade Commission cases must be followed in this situation and the investigatory powers of the commission declared unconstitutional as a violation of the Fourth Amendment?

It is apparent that the major stumbling block confronting the validity of the investigatory powers under this act is the rule set out at the beginning of this comment, that the extent of permissible regulation depends on the extent of the public interest involved. It must also be apparent that the uncritical use of the phrase "affected with a public interest" which has been made up to this point must be abandoned in order to determine whether that aspect of business which is attempted to be regulated by this act may constitutionally be regulated. In other words, when is a business "affected with a public interest" so that it may be regulated by the government without a denial of due process?

Without reviewing the decisions from *Munn v. Illinois*⁴⁶ on down touching on this question, it will be sufficient to refer to the case of *Nebbia v. New York*,⁴⁷ which is a recent decision of the Supreme Court on the problem and a departure from the view taken in the older cases. In that case the power of the New York legislature to set up a Milk Control Board to fix retail prices for milk was upheld. In the course of the opinion Justice Roberts says:⁴⁸

"The Fifth Amendment, in the field of federal activity, and the Fourteenth, as respects state action, do not prohibit governmental regulation for the public welfare. They merely condition

of any books, papers, or other documents which the Commission deems relevant or material to the inquiry." 15 U. S. C., § 77s (1935).

"Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing, under oath or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts." 15 U. S. C., § 77t (1935).

⁴⁶ 94 U. S. 113, 24 L. Ed. 77 (1877).

⁴⁷ 291 U. S. 502, 54 S. Ct. 505 (1934).

⁴⁸ *Ibid.*, 291 U. S. at 525 and 536.

the exertion of the admitted power, by securing that the end shall be accomplished by methods consistent with due process. And the guaranty of due process, as has often been held, demands only that the law shall not be unreasonable, arbitrary, or capricious, and that the means selected shall have a real and substantial relation to the object sought to be obtained. . . .

"It is clear that there is no closed class or category of businesses affected with a public interest, and the function of the courts in the application of the Fifth and Fourteenth Amendments is to determine in each case whether circumstances vindicate the challenged regulation as a reasonable exertion of governmental authority or condemn it as arbitrary or discriminatory. The phrase 'affected with a public interest' can, in the nature of things, mean no more than that an industry, for adequate reason, is subject to control for the public good."

The phrase "affected with a public interest" is thus shown not to be a talisman opening the door to governmental regulation, but merely one of those convenient and often misleading legal shortcuts around a complicated problem. If an evil exists which it is in the public interest to remedy by regulation of the business, if the means undertaken to regulate the business are within the power of the government, and if the means have a reasonable relation to the end desired and are neither arbitrary nor discriminatory, then, under the theory of the *Nebbia* case, the business is "affected with a public interest" and the regulation is valid.

That the unrestricted issue of securities with no protection of the public from fraud is an evil there can be little doubt in view of the millions of dollars which have been mulcted from the public through fraudulent security issues in the past.⁴⁹ It cannot be denied that some sort of regulation of such issues is necessary in this situation where the purchaser has no means of obtaining information concerning that which he buys. The doctrine of caveat emptor under the circumstances is merely a cynical jest.

That the Federal Government has the power to control the business through the means which are chosen in this act, control of the mails and the means of interstate commerce, seems probable under the authority of the cases upholding the prohibition of these methods

⁴⁹ See "Legal Aspects and Need of Federal Securities Regulation," prepared by the Department of Commerce and appearing in HEARING BEFORE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE ON H. R. 4314, 73d Cong., 1st sess. (1934), p. 87, reprinted in CCH Securities Act Service, p. 25. And see James, "The Securities Act of 1933," 32 MICH. L. REV. 624 (1934).

of transportation to lottery tickets and to forged bills of lading.⁵⁰ The federal power to prevent the use to defraud of means under its control must certainly be large enough to include prohibiting their use to fraudulent prospectuses and securities.

That the means used bear a reasonable relation to the end desired, and are not arbitrary and discriminatory, must be conceded when it is considered how many state blue-sky laws utilizing a very similar mechanism have been upheld.⁵¹

If the foregoing be a correct analysis, then the Securities Act is not a denial of due process and the issuers of securities may constitutionally be regulated. The question remains as to whether the investigatory powers conferred on the Securities and Exchange Commission by the Act authorize unreasonable search and seizure. Assuming that the business may constitutionally be regulated then the problem becomes one of deciding whether the inquisitorial powers are essential to an efficient enforcement of the regulatory powers. If so, as we have seen, they are not "unreasonable."

The commission is given by the act both a broad power to investigate when, in its opinion, investigation is necessary,⁵² and a power to conduct an "examination" to determine whether a stop order should issue.⁵³ Can it be contended that the commission can serve its purpose of *preventing* the advertisement and sale of false and fraudulent securities without full power to investigate the financial condition of the issuers? Obviously it has duties to perform before the securities are put on sale, before there is a possibility of a violation of the law. Unless the commission knows whether the facts to be utilized in advertising a security are true, it cannot prevent the sale of fraudulent stock issues, and it cannot discover the truth or falsity of the advertisement without

⁵⁰ Lottery Case, 188 U. S. 321, 23 S. Ct. 321 (1903); United States v. Ferger, 250 U. S. 199, 39 S. Ct. 445 (1919); Jones v. Securities & Exchange Comm., (C. C. A. 2d, 1935) 79 F. (2d) 617, revd. on other grounds, 298 U. S. 1, 56 S. Ct. 654 (1936).

⁵¹ See cases collected in annotations 15 A. L. R. 262 (1921), 24 A. L. R. 523 (1923), 27 A. L. R. 1169 (1923), 30 A. L. R. 1331 (1924), 40 A. L. R. 1014 (1926), 54 A. L. R. 498 (1928), and 57 A. L. R. 1004 (1928).

⁵² 94 U. S. 113, 24 L. Ed. 77 (1877).

⁵³ "The Commission is hereby empowered to make an examination in any case in order to determine whether a stop order should issue under subsection (d). In making such examination the Commission or any officer or officers designated by it shall have access to and may demand the production of any books and papers of, and may administer oaths and affirmations to and examine, the issuer, underwriter, or any other person, in respect of any matter relevant to the examination. . . . If the issuer or underwriter shall fail to cooperate or shall obstruct or refuse to permit the making of an examination, such conduct shall be proper ground for the issuance of a stop order." 15 U. S. C., § 77h (e) (1935).

an investigation. So far as the necessity of the inquisitorial powers to the regulation attempted is concerned, this would seem to be an even clearer case for upholding the powers than the stock exchange regulation.

The cases which have been decided on the question have so far not passed directly on the point of the validity of these powers. They have, rather, skirted the subject. The Supreme Court's only decision bearing on the subject, in *Jones v. Securities and Exchange Commission*,⁵⁴ instead of passing on the question of their validity, holds that the investigation in that case was not justified anyhow under the statute as the registration statement had been withdrawn by the issuer.⁵⁵ The Circuit Court of Appeals in the same case upheld the constitutionality of the powers,⁵⁶ but, as its decision was reversed by the Supreme Court on another ground, the holding is dubious authority. Likewise in the case giving rise to this discussion, *Newfield v. Ryan*, it is held that the demand of the Commission for telegrams from a telegraph company constitutes "demand by other lawful authority" under the Federal Communications Act, and the sender of the telegrams cannot raise the constitutional issue.⁵⁷ In the case of *McMann v. Securities and Exchange Commission*⁵⁸ the decision avoids the question by pointing out that a broker from whom information is sought concerning the accounts of a client is not in a position to raise the constitutional question.⁵⁹

The question, then, is still an open one. It is submitted that the business of security issuers may fairly be found to be one fraught with danger to the public and constitutionally subject to regulation, that the regulation undertaken is reasonable, and that the inquisitorial powers conferred on the commission under the Securities Act of 1933 and the Securities Exchange Act of 1934 are necessary to the regulation involved and are not, therefore, an unreasonable search and seizure.

Brackley Shaw

⁵⁴ 298 U. S. 1, 56 S. Ct. 654 (1936).

⁵⁵ Although this decision has been criticized, e.g. 34 MICH. L. REV. 1031 (1936), 84 UNIV. PA. L. REV. 1019 (1936), and 49 HARV. L. REV. 1369 (1936), it would seem that it probably expresses the intent of Congress. All policy arguments aside, it may be seen by comparing the statute quoted in note 53 with those in notes 44 and 45 that in this clause Congress provides for an "examination" and in the others for an "investigation," that the power to subpoena is not given in connection with such examination in specific terms, and that an unusual sanction for punishing obstruction of the commission's investigation, the stop order, is provided, presumably to take the place of contempt of court on refusal to obey a subpoena.

⁵⁶ *Jones v. Securities & Exchange Comm.*, (C. C. A. 2d, 1935) 79 F. (2d) 617, where the search and seizure question was not discussed.

⁵⁷ (C. C. A. 5th, 1937) 91 F. (2d) 700 at 703.

⁵⁸ (C. C. A. 2d, 1937) 87 F. (2d) 377, cert. denied, 301 U. S. 684, 57 S. Ct. 785 (1937).

⁵⁹ 87 F. (2d) at 379.