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Securities Law -- Exchange Liability Under Section 6(b) of the Securities Exchange Act of 1934 -- Hughes v. Demsey-Tegeler & Co., Inc.

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security afforded by the rules in *Arnett v. Kennedy*[256] and *Perry v. Sindermann*.[257] *Arnett v. Kennedy* recognized a protected property interest in public employment deriving from a statute which conditions discharge upon cause.[258] *Bishop* indicates that this result may be avoided through deference to another court's interpretation of governing law, even should that interpretation disregard the teachings of *Arnett v. Kennedy*.[259] Similarly, expectations of continued employment fostered by circumstances, protected under *Perry v. Sindermann,* now provide an insecure basis for a due process claim, as the *Bishop* decision suggests that property interests in state employment are dependent upon state law,[260] which apparently may exclude interests implied in the surrounding circumstances.

Paul v. Davis and *Bishop v. Wood* indicate that the words "liberty" and "property" in the due process clause will no longer be read expansively, as protection of asserted rights is made increasingly dependent upon state law. Moreover, in an apparent departure from recent decisions, the Court in *Davis* and *Bishop* seems to have allowed concern for the state interests implicated in these cases to influence the threshold identification of the personal interest infringed by the state.[261] In previous cases, consideration of the state interest was reserved for the weighing process which determines the degree of procedure required once a constitutionally protected interest has been identified.[262] The *Davis* and *Bishop* opinions thus evidence increased solicitude for the interests of the state to the corresponding detriment of the personal interest at stake.

MAUREEN FOX

Securities Law—Exchange Liability Under Section 6(b) of the Securities Exchange Act of 1934—Hughes v. Dempsey-Tegeler & Co., Inc.[1] Plaintiff, Reuben P. Hughes, a businessman and private investor, brought suit against both Dempsey-Tegeler & Co., Inc. (Dempsey) a broker-dealer and member of the New York Stock Exchange (Exchange), and the Exchange itself, to recover losses sustained when certain securities subordinated by Hughes in favor of Dempsey were sold for the benefit of creditors upon Dempsey's liquidation.[2] Hughes alleged that members of Dempsey had fraudu-

[256] 416 U.S. 134 (1974).
[257] 408 U.S. 593 (1972).
[258] See note 190 *supra*.
[259] See § IIA *supra*.
[260] See § IIB *supra*.
[261] See § III *supra*.
[262] *Id.*

[1] 534 F.2d 156 (9th Cir.), *cert. denied*, 97 S.Ct. 259 (1976).
[2] *Id.* at 160. The claims against Dempsey were dismissed by the court. *Id.* at

lently induced him to enter into the subordination agreement, and that the Exchange had breached its statutory duty to enforce its rules against Dempsey both by allowing the firm to solicit subordinated capital and by removing restrictions it had previously placed on the firm.[3] In challenging the adequacy of the actions taken by the Exchange for the purpose of stabilizing a member firm operating in violation of Exchange rules, the suit raised unique questions concerning stock exchange liability and the appropriate scope of judicial review.

The Exchange's involvement with Dempsey began after the company met with a series of financial difficulties culminating in its inability to comply with Exchange rules. Dempsey was one of many stock brokerage firms plagued by financial and operational difficulties during the late 1960's.[4] These problems stemmed primarily from an inability to keep pace with a vastly increased trading volume.[5] Dempsey's problems were further exacerbated by its particular method of diversified accounting.[6] An Exchange audit in 1968 finally revealed that Dempsey was in violation of both the Exchange's net capital[7] and recordkeeping[8] rules.

175-77, and will not be discussed in this article.

[3] *Id.* at 160.

[4] *Id.* at 161.

[5] *Id.* See notes 156-60 *infra* for a discussion of the industry conditions at this time, and *see* SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 231, 92d Cong., 1st Sess. 13 (1971).

[6] Dempsey used an internal method of branch offices reporting to regional accounting centers. 534 F.2d at 162.

[7] *Id.* Rule 325 of the New York Stock Exchange requires that:

> [n]o member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to superivison by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.
>
> The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.
>
> The Exchange may at any time or from time to time in the case of the particular member or member organization prescribe greater requirements than those prescribed herein.
>
> Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule.

NYSE GUIDE (CCH) ¶ 2325, at 3525 (1969).

The Net Capital rule is one of the most important Exchange rules in terms of investor protection. J.R. Williston & Beane, Inc. v. Haack, 387 F. Supp. 173, 179 (S.D.N.Y. 1974). It assures the financial integrity of broker-dealers by setting a ratio of their aggregate indebtedness to their net capital. Thus broker-dealers are prevented from operating unless they have the required cash or liquid assets available. *Id.*

[8] 534 F.2d at 162. Rule 342, NYSE GUIDE (CCH) ¶ 2452.10, at 3585 (1969), and

Pursuant to its constitution, the Exchange had the authority to suspend Dempsey if it appeared that continued operation of the firm while in violation of these rules endangered either the firm's creditors or the Exchange's safety.[9] However, as an alternative to suspension, the Exchange "invoked a measured response against Dempsey by levying certain sanctions against its business and management."[10] Specifically, the Exchange prohibited the firm from advertising or adding new representatives; placed a ceiling on the volume of weekly trading; and demanded an infusion of new capital.[11]

Despite the imposition of restrictions, a second Exchange audit revealed that Dempsey was close to insolvency.[12] This situation prompted the first in a series of meetings between the Exchange, Dempsey, and the Securities and Exchange Commission (Commission).[13] As a result of the initial meeting, the Exchange placed further restrictions on Dempsey and the Commission informed Dempsey that it would refuse to approve any new underwritings by the firm.[14]

Dempsey's continued financial problems and the prophylactic measures taken by both the Exchange and the Commission lay the groundwork for Hughes' eventual involvement with the firm. Hughes was approached by an officer of Dempsey with the suggestion that he subordinate a large share of his municipal bond holdings to the firm.[15] At the same time, Dempsey also was negotiating with John King, president and majority stockholder of King Resources, for an additional subordinated loan.[16] The negotiations between Dempsey

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440, *id.* ¶ 2440.10, at 3781, require member broker-dealers to maintain accurate records. This insures that the financial position of the firm can quickly be ascertained.

[9] Article XIII, NYSE GUIDE (CCH) ¶ 1602, at 1084 (1969). Section 2 of Article XIII of the Exchange Constitution provides:

> Whenever it shall appear to the Chairman of the Board that a member has failed to meet his engagements, or is insolvent, or the Chairman of the Board has been advised by the Board of Governors or by the Board of Directors of Stock Clearing Corporation that such member is in such financial or operating condition that he cannot be permitted to continue in business with safety to his creditors or the Exchange, prompt notice thereof shall be given to the Exchange. Such member shall thereby become suspended from membership until he has been reinstated as provided in Section 5 of this Article (¶ 1605).

If a member-dealer does not fall under Article XIII Section 2 he may be suspended for a rule violation under Article XIV, Section 6, *id.* ¶ 1663, at 1087, which permits the Exchange to reduce the penalty in cases where it may impose suspension.

[10] Hughes v. Dempsey-Tegeler & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, 94,528 (C.D. Cal. 1973).

[11] *Id.* at 94,532. The Exchange also fined the firm $100,000, the president $50,000, and a vice-president $5,000. *Id.*

[12] 534 F.2d at 162.

[13] *Id.*

[14] *Id.* The Exchange ordered Dempsey to close 50% of its branches and it suspended Dempsey's president, Jerome Tegeler, for one year. *Id.*

[15] *Id.* at 163.

[16] Hughes v. Dempsey-Tegeler & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,530 (C.D. Cal. 1973).

and King were closely scrutinized by the Commission.[17] Through its independent investigation of Dempsey and other broker-dealers, the Commission knew that "serious difficulties existed with respect to its [Dempsey's] internal management, accounting and capital requirements."[18] Despite this knowledge, the Commission refrained from official action, and left the Exchange free to stabilize Dempsey through the solicitation of subordinated capital.[19]

Having watched the King negotiations carefully, "the Commission expedited the registration of King's stock with the knowledge that it would be used for the Dempsey subordination."[20] Upon completion of the King negotiations, the Exchange lifted its restrictions on Dempsey.[21] The Commission paralleled this action by lifting its ban on Dempsey's underwritings.[22] Subsequently, learning of the successful completion of the King negotiations, Hughes subordinated his securities to Dempsey.[23]

Immediately following the completion of the King and Hughes subordination agreements, the stock market suffered an unexpectedly sharp and prolonged decline.[24] This market drop, especially in the value of the King stock,[25] which constituted the basis of Dempsey's financial position, coincided with a general decline in trading and provided a lethal blow to Dempsey.[26] In response to Dempsey's new dif-

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[17] *Id.*

[18] *Id.* at 94,531-32.

[19] *Id.* at 94,532. The district court found a "gentlemen's agreement" between the Exchange and the Commission whereby the Exchange "would seek to order its organization in its own fashion, without 'official' pressures from the Commission." *Id.*

[20] *Id.* at 94,533. The King agreement was in the form of demand notes totaling seven million dollars to be secured by King Resources stock with a market value of ten million dollars, held in escrow. The Commission advised the Exchange that the stock was marketable and thus qualified as capital for Dempsey. *Id.* at 94,530.

[21] 534 F.2d at 164. See text at notes 11-14 *supra* for a discussion of these restrictions.

[22] *Id.* at 174. Dempsey still had operational problems which were the result of an inability of its recordkeeping to keep pace with the previous volume of business. The Exchange believed that Dempsey's main problem had been a failure of the firm's management to organize efficient back office procedures. To remedy this problem, the Exchange had already suspended the firm's president, and had hired Robert Peck, an accountant who had resolved similar problems at Hayden Stone, another brokerage firm. Brief for Appellee at 15, 70, Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 172 (9th Cir. 1976).

[23] Hughes' agreement with Dempsey contemplated that Hughes would continue collecting interest from his securities while receiving interest payments on the loan itself at a rate of one half of one percent above prime rate. Had Dempsey not been liquidated, Hughes would have realized $80,000. Hughes v. Dempsey-Tegeler & Co., Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,530 (C.D. Cal. 1973).

[24] *Id.* at 94,536-37. The New York Stock Exchange Index dropped approximately 25%. *Id.* at 94,536. The market value of the King stock declined from $23 per share in March, 1970, to $6 in May of 1970. *Id.* By July of 1970 there was no market for the King stock and it was valued at only $1.50 per share. *Id.* at 94,536-37. The district court held that this market plummet, coinciding with a recession in trading, was not foreseeable at the time of the loans. *Id.* at 94,537.

[25] *Id.* at 94,536.

[26] *Id.*

ficulties, the Exchange determined that Dempsey would be unable to meet the demands of the firm's creditors. It subsequently proceeded to liquidate the firm.[27]

Upon Dempsey's liquidation, Hughes brought suit against the Exchange, contending that the Exchange had violated the affirmative duty to enforce its own rules[28] pursuant to section 6(b)[29] of the Securities Exchange Act of 1934 (Act).[30] Specifically, Hughes alleged that Dempsey's violation of the Exchange's net capital and record-keeping rules mandated suspension of the firm, and that the Exchange's subsequent removal of the restrictions placed on Dempsey as an alternative to suspension[31] while the firm continued to be in violation of Exchange rules was a further breach of the Exchange's section 6 duty.[32] The district court held that the implementation of restrictive measures short of suspension was within the "broad" discretion of the Exchange and was inherent in its self-regulatory nature.[33] Further, the court reasoned that the removal of the restrictions while the firm continued to face financial problems was implemented as a result of an Exchange determination both that the subordinated securities might solve Dempsey's difficulties and that continued imposition of the restrictions would have been tantamount "to a termination of Exchange support and backing . . . ."[34] Moreover, the court noted

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[27] *Id.*

[28] 534 F.2d at 160. For a discussion of the duty owed by an exchange under § 6 see Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944). This case is discussed in the text at notes 82-92 *infra.*

[29] 15 U.S.C. § 78f(b) (1970). This section provides:

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

[30] 15 U.S.C. § 78a *et seq.* (1970).

[31] See text at notes 11-14 *supra* for a discussion of these restrictions.

[32] Hughes v. Dempsey-Tegeler & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,544 (C.D. Cal. 1973). Hughes alleged several other causes of action. The first alleged violation of § 10(b) of the Securities Exchange Act. 15 U.S.C. § 78j(b), of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976) and of §§ 12(2) and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77l(2), 77q, by Dempsey, and by two of its officers. 534 F.2d at 160 n.1. The second cause of action alleged a violation of § 29(b) of the Securities Exchange Act, 15 U.S.C. 78cc(b), and § 12(2) of the Securities Act of 1933 by Dempsey, and sought recission for the violations stated in the first cause of action. 534 F.2d at 160 n.1. Third, Hughes alleged violations of § 10(b) of the Securities Exchange Act and of Rule 10b-5 by the Exchange. *Id.* A fourth cause of action alleged a violation of § 10(b), of Rule 10b-5, and of §§ 12(2) and 17 of the Securities Act of 1933 by the Exchange. *Id.* Fifth, Hughes sought declaratory relief against the Exchange. Finally, he alleged that Dempsey had violated California's Corporate Code. *Id.*

[33] Hughes v. Dempsey-Tegeler & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,546 (C.D. Cal. 1973). See text at notes 64-80 *infra* for a discussion of self-regulation.

[34] *Id.* at 94,546.

that the Exchange feared that the alternative of placing Dempsey in receivership might cause a "crisis" within the industry because of an "inevitable, public loss of confidence."[35] Accordingly, the district court held that the Exchange's decision to lift its restrictions, while presumptuous, was "implemented in good faith" and was therefore not an abuse of discretion.[36] On appeal, the Ninth Circuit reversed the district court and HELD: although the original imposition of restrictive measures was within the Exchange's discretion, their later removal was a "clear" breach of the Exchange's section 6 duty.[37] Hughes' right to recovery however, was barred by the doctrine of waiver, since he was found to have possessed both full knowledge that the restrictions on Dempsey were lifted prior to his loan and full knowledge of the risks that he was assuming.[38]

In finding a "clear" breach of duty by the Exchange, the court of appeals undertook to examine the "reasonableness" of Exchange action.[39] As such, the court appears to have predicated liability on a standard far stricter than that traditionally employed in reviewing action committed to agency discretion.[40] The standard employed in "committed to agency discretion"[41] cases merely requires an examination of the record for an abuse of discretion. The court's stricter approach thus raises crucial questions with respect to the future parameters of exchange duty and potential liability under federal securities regulation.

This article will first present the rationale employed by the court of appeals in finding that the Exchange breached its duty. In so doing, it will demonstrate that even though the court invoked "abuse of discretion" language, it actually applied a much more stringent negligence standard heretofore employed only when an exchange had failed to take action. The article will next analyze the statutory framework of securities regulation with a view toward determining the proper limits of stock exchange discretion. The propriety of a negligence standard as compared to an abuse of discretion standard will then be discussed in two contexts. First, this article will examine the scope of discretion that is necessary, on a working level, to enable an exchange to take appropriate remedial action. Second, this article will determine which standard of liability best serves to effectuate the statutory scheme of self-regulation and how such a standard should be applied to the merits of the *Hughes* decision. Finally, the potential

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[35] *Id.* at 94,532.

[36] *Id.* at 94,546.

[37] 534 F.2d at 174.

[38] *Id.* at 174-75.

[39] *Id.* at 170.

[40] An exchange, while a private body, functions in many ways like a governmental agency and when it does so it should be subject to the same standard of review. See text at notes 122-25 infra.

[41] See text at notes 55-56 *infra*.

found in the 1975 Securities Act Amendments[42] to resolve questions of both stock exchange liability and the appropriate scope of review will be analyzed.

I. THE *Hughes* DECISION

In examining the propriety of the Exchange's response to Dempsey's financial problems, the court of appeals attempted to identify generally the point at which the desirable preservation of flexibility in stock exchange action becomes an unacceptable license for "completely discretionary enforcement."[43] The court emphasized both the importance of exchange discretion in regulating the securities industry and its corollary, the necessity of a narrow scope of judicial review.

> As long as the Exchange takes prompt actions to investigate alleged violations, and, having ascertained that violations exist, takes action reasonably designed to restore compliance with the rules, courts should not substitute their retrospective judgment concerning the appropriate action.[44]

However, the court never precisely defined the parameters of permissible exchange action. The minimal "guidelines" suggested by the court included only a rejection of a standard allowing complete discretion on the part of an exchange;[45] a finding that an action taken in good faith was insufficient to shield an exchange from liability;[46] and a recognition of the fact that the Commission's endorsement or nonendorsement of an exchange's actions might, on a case-by-case basis, be a factor in determining exchange liability.

In applying this nebulous standard to the facts of *Hughes*,[47] the court first found that although the Exchange constitution mandates suspension of a firm when the firm cannot guarantee its safety to its creditors or to the Exchange,[48] the determination of whether such a condition exists is open to discretionary interpretation.[49] Therefore, the *imposition* of restrictions on Dempsey pursuant to the rule violation was found to be a permissable exercise of Exchange authority.[50] The court then turned to an examination of the subsequent *removal* of the restrictions. It weighed the "sufficiency" of this action and found an

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[42] Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).
[43] 534 F.2d at 169.
[44] *Id.* at 170.
[45] *Id.* at 169.
[46] *Id.* at 167.
[47] *Id.* at 173.
[48] See note 9 *supra* for text of this section of the Exchange Constitution.
[49] 534 F.2d at 173.
[50] *Id.*

abuse of discretion which subjected the Exchange to liability.[51] In reaching this latter determination, the court, reasoned that the restrictions were placed on Dempsey to reduce its business to a level where it could function properly.[52] From this determination the court concluded that "in lifting the restrictions, the Exchange invited an aggravation of the very problems which had prompted the restrictions in the first place."[53] Although the court apparently was "bothered" by the Commission's concurrent removal of its underwriting ban on Dempsey, it nevertheless concluded that the Commission's parallel action could not be accorded conclusive weight because the Exchange's breach of duty was so clear.[54] Based upon this analysis the court held that in taking this subsequent action the Exchange abused its discretion and breached its section 6 duty.

While the court phrased its holding in terms of "abuse of discretion,"[55] it seemingly applied a more stringent standard in evaluating the Exchange's decision to remove the restrictions placed upon Dempsey. In a traditional abuse of discretion test the court's function is simply to examine the record to see if there is some rational basis upon which the decision could have been made.[56] Only if there is no rational basis for a decision can the action be viewed as arbitrary or capricious, necessitating a finding of abuse of discretion and therefore a breach of duty. A reviewing court thus avoids the possibility of substituting its independent evaluation for that of the more expert body.

In finding that there was no evidence to support the Exchange's decision to remove the restrictions,[57] the *Hughes* court may have concluded that the removal of restrictions was arbitrary, as having no basis in the record, and was therefore an abuse of discretion. However, a closer analysis reveals that the court predicated the Exchange's breach of duty on a different standard altogether. While the court found *no* evidentiary support for the Exchange's decision, it summarily discounted the probative weight of the evidence which the Exchange did present. For example, the court determined that the addition of the new capital was not related to Dempsey's organizational problems,[58] and therefore would not serve as a rational basis for the decision. In so doing, the court seemingly ignored the finding of the district court that the Exchange believed that the loan might solve

[51] *Id.* at 174.

[52] *Id.*

[53] *Id.*

[54] *Id.* This decision gained a 2-1 majority. One judge concurred in the result but agreed with the district court that the Exchange had not abused its discretion. *Id.* at 178. The other judge concurred in the opinion in part but dissented from the judgment because he disagreed with the court's finding of waiver. *Id.* at 179-85.

[55] See text at notes 82-95 *infra*.

[56] K. DAVIS. ADMINISTRATIVE LAW TEXT 549-51. (3d ed. 1972).

[57] 534 F.2d at 174.

[58] *Id.*

Dempsey's problems.[59] It also seemed to ignore the fact that Dempsey had instituted new leadership designed to correct the previous mismanagement. Further, although the court specifically found that the role of the Commission could serve as a relevant factor in determining whether there was a rational basis for Exchange action,[60] it discounted the Commission's role in this case.[61] It would seem, then, that there was record evidence before the reviewing court which indicated some rational basis for the Exchange's decision to lift the restrictions. Yet, the court reasoned in finding a breach of duty, that "[e]ither the restrictions were not a sufficient response to Dempsey's problem in the fall of 1969, indicating a breach of duty at that time or they were a sufficient response indicating that their subsequent removal was a breach of duty in March of 1970."[62] Thus in assessing the sufficiency of Exchange action it appears that the court did not simply decide that there was *no* rational basis for the removal of restrictions. Rather the court engaged in an independent weighing process to find a breach of duty. In so doing the court failed to employ the "rational basis" standard used in abuse of discretion cases and substituted its own stricter test.

II. THE STATUTORY SCHEME

A. *Statutory Language and Legislative History*

Having based Exchange liability on an independent determination of the sufficiency of Exchange action under the circumstances,[63] the Ninth Circuit in *Hughes* apparently departed from a traditional abuse of discretion test and moved toward a standard which approached a negligence test. While a negligence standard of review has previously been employed when an exchange has failed to take remedial action[64] it has never been extended to measure exchange liability when action has been taken.

The appropriateness of negligence as a standard for judicial review of exchange action can best be assessed by examining the statutory framework governing the securities industry with a view toward determining what permissible range of discretion is provided therein. The Securities Exchange Act invests stock exchanges with direct responsibility for regulating much of the securities industry. Congress apparently thought that the Commission would be incapable, both in

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[59] Hughes v. Dempsey-Tegeler & Co., Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,546 (C.D. Cal. 1973).

[60] 534 F.2d at 171.

[61] *Id.* at 174.

[62] *Id.*

[63] *See* W. PROSSER, THE LAW OF TORTS 148-49 (4th ed. 1971), for the proposition that a negligence standard implies a balancing test by the court.

[64] *See* Baird v. Franklin, 141 F.2d 238, 239 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944). This case is discussed in the text at notes 83-95 *infra*.

terms of manpower and expertise, of detailed oversight of such a vast industry.

> Stock exchanges raise essentially new problems in Federal regulation. They do not present a static situation susceptible to fixed standards. On the contrary, it is a highly dynamic, everchanging picture, subject to untold and unknown possibilities and combinations that are today unpredictable. *The thing to be avoided is the placing of this complex and important mechanism in a strait jacket.*[65]

This general philosphy was carried over into the provisions which directly regulate the exchanges themselves. Section 6 of the Act sets out the registration requirements for a securities exchange. The registration process is initiated through submission by the exchanges of their rules, whether in the form of a constitution, by laws, or articles to the Commission. For a registration to be granted, the Commission must then determine that these rules are "just and adequate to insure fair dealings and protect investors . . . ."[66] In order to insure investor protection, exchange rules must contain enforcement provisions. Section 6(b) of the Act mandates that an exchange provide rules for the "expulsion, suspension, or disciplining of a member for conduct . . . *inconsistent with the just and equitable principles of trade* . . . ."[67]

The language of this statutory mandate, viewed as a standard of conduct to which the exchanges must adhere, appears quite general. Indeed, the degree of discretion implied in the use of the phrase "just and equitable principles of trade" could hardly seem broader.[68] Thus, from the language of section 6(b) itself it can be inferred that in enacting this provision, Congress did not intend that violations of all rules promulgated thereunder would serve as a basis for liability.[69] This language further indicates that those violations which are to subject an exchange to liability should be reviewed in a manner consistent with the broad discretionary language of the statute.

Another aspect of the statutory scheme also comports with the notion of allowing an exchange considerable discretion in complying with its statutorily mandated standard of conduct. In order to protect investors, Congress sought to control the securities industry through a comprehensive scheme of self-regulation, with general governmental

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[65] STOCK EXCHANGE REGULATION, LETTER FROM THE PRESIDENT OF THE UNITED STATES TO THE CHAIRMAN OF THE COMMITTEE ON BANKING AND CURRENCY WITH AN ACCOMPANYING REPORT RELATIVE TO STOCK EXCHANGE REGULATIONS, 73d Cong., 2d Sess. 6 (Senate Committee Print 1934) (emphasis added) [hereinafter cited as ROPER REPORT].

[66] 15 U.S.C. § 78(f) (1970).

[67] Id. at § 78f(b) (emphasis added).

[68] For discussion of § 6(b) as a standard of conduct see Colonial Realty Corporation v. Bache & Co., 358 F.2d 178, 181 (2d Cir. 1966) (Friendly, J.).

[69] *Id.*

oversight by the Commission.[70] To this end, the Commission in its supervisory capacity was given broad powers to regulate directly various areas of the industry. For example, section 11[71] provides for direct regulation of floor trading. Further, section 19(a)[72] authorizes the Commission to suspend an exchange for failure to enforce its rules, and until amended in 1975,[73] section 19(b) gave the Commission authority to "alter or supplement" exchange rules in twelve specific areas.[74] In most cases, however, the Commission has deferred exercise of these powers to exchange authority.[75] This deference is seemingly consistent with Congressional intent, for the apparent theory underlying Congress' broad grant of powers to the Commission is that they should be held in reserve, to be used only to the extent necessary to fill the gaps where self-regulation proves inadequate.[76] Thus Congress sought to leave the policing of the intricacies of the securities industry

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[70] H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934). *See also* ROPER REPORT, *supra* note 65, at 5-8.

[71] 15 U.S.C. § 78k (1970).

[72] *Id.* at § 78s(a).

[73] See text at notes 175-77 *infra*.

[74] 15 U.S.C. § 78s(b) (1970). This section provided:

> The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial 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.

[75] 4 SEC, REPORT OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. 698 (1963) [hereinafter cited as SPECIAL STUDY].

[76] *See id.* at 697-98. The legislative history of the Act supports the theory that Commission power is to be held in reserve, giving the exchanges the primary role of policing the industry through a system of self-regulation. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934). *See also* ROPER REPORT, *supra* note 65, at 5-8.

to those most capable of performing it—namely the exchanges and the Commission.[77]

In performing their self-regulating functions, the exchanges, although private bodies, effectively have been delegated governmental authority.[78] This delegation is appropriate because an exchange is the only body which commands the necessary expertise to ascertain quickly all the relevant facts and to make the critical daily evaluations and decisions concerning rule enforcement. In order to use this authority properly, an exchange cannot be subject to constant second-guessing by a judiciary which, by its very nature, has limited contact and expertise in this area.[79] The exchanges will only exercise the decision-making responsibility envisioned by Congress and heretofore encouraged by judicial deference if the exchanges are not subjected to a standard of judicial review which inhibits exchange initiative.[80]

B. *Judicial Implication of a Remedy and Development of a Standard of Exchange Liability*

While it is recognized that exchanges need considerable latitude in exercising their self-policing authority, investing them with too great a degree of discretion would appear to be inconsistent with the Congressional intent in enacting the Securities Exchange Act of 1934. Although Congress manifested concern with ensuring exchanges broad flexibility, it attempted to do so only within the framework of the more important goal of protecting the investing public from arbitrary abuses by unregulated securities exchanges.[81] Thus, while the Act does not afford an express remedy to an investor injured by an exchange's failure to fulfill its section 6 obligation to enforce its rules,[82] the courts have filled this gap by implying a private right of action when an exchange has breached its section 6 duty by failing to enforce its rules. Judge Clark, in *Baird v. Franklin*,[83] laid the ground-

[77] *But cf.*, Note, *Exchange Liability for Net Capital Enforcement*, 73 COLUM. L. REV. 1262, 1284-87 (1973) (The author would severely limit exchange discretion when a broker-dealer is in violation of the net capital rule).

[78] SPECIAL STUDY, *supra* note 75 at 697.

[79] "A nongovernmental agency having responsibility to carry out public regulatory objectives cannot be expected to exercise the full measure of responsibility if the Commission is looking over its shoulder and directing or second-guessing each individual action that it takes." *Id.* at 703. The logic of this would appear to apply equally as well to the courts since they are not even charged with oversight of the securities industry as is the Commission.

[80] Carr v. New York Stock Exchange, Inc., 414 F. Supp. 1292, 1298 (N.D. Cal. 1976); Rich v. New York Stock Exchange, 379 F. Supp. 1122, 1126 (S.D.N.Y. 1974), *rev'd on other grounds*, 522 F.2d 153 (2d Cir. 1975). *See also* text at notes 121-25 *infra*.

[81] *See* Silver v. New York Stock Exchange, 373 U.S. 341, 349-52 (1963). *See generally* ROPER REPORT, *supra* note 65.

[82] *See, e.g.*, Baird v. Franklin, 141 F.2d 238, 239 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); Marbury Management, Inc. v. Kohn, 373 F. Supp. 140, 142 (S.D.N.Y. 1974); Pettit v. American Stock Exchange, 217 F. Supp. 21, 29 (S.D.N.Y. 1963).

[83] 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

work for this private right of action against an exchange by basing exchange liability on a tort negligence theory.[84] In *Baird*, the New York Stock Exchange failed to take remedial action after obtaining knowledge that a senior partner of a member firm had converted an investor's securities.[85] A majority of the Second Circuit acknowledged that the Exchange owed a duty to act, but denied relief because the investors had failed to prove that the Exchange's negligence was the cause of their losses.[86]

Dissenting on the issue of causation,[87] Judge Clark, in his statutory interpretation of section 6 set forth the theory on which a private right of action subsequently has come to rest. He reasoned that to hold an exchange to a duty to promulgate rules for "expulsion, suspension, or disciplining of a member . . . ," as set out in section 6(b),[88] without imposing a concomitant duty of enforcement, would render the section meaningless.[89] Therefore, section 6(b) had to be read in conjunction with section 6(d),[90] which grants a registration to an exchange only on a determination by the Commission that exchange rules are "just and adequate to insure fair dealing and to protect investors . . . ,"[91] as implying a twofold obligation on the exchange both to promulgate and then to enforce its rules.[92] While this

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[84] 141 F.2d at 245-46 (Clark, J., dissenting). For a general discussion of the development of private remedies under the Act see Shipman, *Two Current Questions Concerning Implied Private Rights of Actions under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 963-1010 (1966).

[85] *Id.* at 241.

[86] *Id.* at 239.

[87] *Id.* at 245 (Clark, J., dissenting).

[88] See note 3 *supra*.

[89] 141 F.2d at 244 (Clark, J., dissenting).

[90] 15 U.S.C. § 78f(d) (1970). This section provides:

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

[91] *Id.*

[92] 141 F.2d at 244 (Clark, J., dissenting). Liability in *Baird* was predicated on negligent violation of a statutory duty. Later cases have interpreted the § 6(a)(1), 15 U.S.C. § 78f(a)(1) (1970), language requiring the "agreement" of an exchange to comply with the provision of the Act to create a contract between the exchange and the SEC. Thus, under this theory, investors are granted a right of action as third party beneficiaries. *See, e.g.*, Arneil v. Ramsey, 414 F. Supp. 334, 340 (S.D.N.Y. 1976); Carr v. New York Stock Exchange Inc., 414 F. Supp. 1292, 1298 (N.D. Cal. 1976); Weinberger v. New York Stock Exchange, 403 F. Supp. 1020, 1028 (S.D.N.Y. 1975); Lank v. New York Stock Exchange, 405 F. Supp. 1031, 1040 (S.D.N.Y. 1975). The difference between the two theories is relevant for statute of limitations purposes, because the period for breach of a statutory duty is usually shorter than the one applicable to breach of contract. *See, e.g.*, Arneil v. Ramsey, 414 F. Supp. 334, 340 (S.D.N.Y. 1976), and cases cited therein. The court in *Hughes* found the duty owed to be the same under either theory. 534 F.2d at 166 n.5. It should be noted that the contract theory may no longer apply

statutory analysis created a duty on the part of an exchange, the *Baird* holding, would have limited exchange liability to instances where the exchange had *actual* knowledge of a rule violation and had subsequently failed to act. The logic of Judge Clark's argument was so forceful, however, that private rights of action were subsequently extended to cases where an exchange had *reason to believe* its rules were being violated, and failed to act.[93] While the courts have broadly interpreted the scope of the implied right under section 6,[94] until *Hughes* they had limited the scope of the duty owed to the investor.

since the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 104 (1975), eliminated the phrase "agreement" from § 6. This would not, however, have any effect on causes of action accruing prior to the effective date of the Amendments. *See* Lank v. New York Stock Exchange, 405 F. Supp. 1031, 1040 n.16 (S.D.N.Y. 1975), *rev'd on other grounds*, No. 76-7243 (2d Cir. Jan. 20, 1977).

[93] *See, e.g.*, Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 368 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974); Butterman v. Walston & Co., Inc., 387 F.2d 822, 825 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968); Marbury Management, Inc. v. Kohn, 373 F.Supp. 140, 143 (S.D.N.Y. 1974); Pettit v. American Stock Exchange, 217 F.Supp. 21, 29-30 (S.D.N.Y. 1963).

Although in Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975), and Cort v. Ash, 422 U.S. 66 (1975), the Supreme Court apparently has limited the scope of implied rights of action, *see generally* Comment, 17 B.C. IND. & COM. L. REV. 53 (1975), it appears unlikely that the implied right would be so restricted as to apply only to public investors, and not to subordinated lenders such as Hughes. *Barbour* was a suit brought by investors of a broker-dealer to compel the Securities Investor Protection Corporation (SIPC) to provide relief to the investors of the financially troubled firm. 421 U.S. at 414. SIPC was the legislative response to situations such as those in *Hughes*. The Securities Investor Protection Act (SIPA), 15 U.S.C. §§ 78aaa *et seq.* (1970) created procedures for an early warning system for troubled securities firms and provided for orderly liquidation of those firms that failed. 421 U.S. at 416. SIPC maintained a fund to meet the obligations to the customers of liquidated firms. *Id.* In this way, SIPA provided protection for investors somewhat in the form of insurance. The Court held that the investors had no implied right of action under the Securities Investor Protection Act (SIPA) which created SIPC. *Id.* at 425. Since SIPA did not expressly provide for a private remedy but did authorize suits by the Commission to compel SIPC to perform its statutory duty, the Court would not imply a private right of action. *Id.* at 417. In reaching this decision the Court found SIPA's policy, to defer possible intervention by SIPC until the last possible instance, inconsistent with implying a private right of action. *Id.* at 422. The Court distinguished SIPA from the Securities Exchange Act of 1934 by finding that SIPA "contains no standards of conduct that a private action could help enforce . . . ." *Id.* at 424. In contrast, § 6(b)'s prohibition against conduct "inconsistent with just and equitable principles of trade," can be read as providing such a standard of conduct for implied rights. Therefore, it is unlikely that *Barbour* will have any effect on suits by subordinated lenders such as Hughes. Courts have always interpreted the scope of protection provided by § 6 broadly enough to include all members of the investing community, including subordinated lenders, who invest in brokerage houses, as well as those who invest in securities. Arneil v. Ramsey, 414 F. Supp. 334, 341 (S.D.N.Y. 1976), and Carr v. New York Stock Exchange, Inc., 414 F. Supp. 1292, 1298 (N.D. Cal. 1976), both decided after *Barbour*, have recognized private rights of action by subordinated lenders under § 6. Moreover, the *Hughes* court did not read *Barbour* as mandating a reversal of the implied right created under § 6. 534 F.2d at 166 n.5. *But see* Lank v. New York Stock Exchange, No. 76-7243 (2d Cir. Jan. 20, 1977). The Second Circuit would not extend the private right beyond public investors, thus excluding members of the exchange community such as brokerage firm creditors. *Id.* slip op. at 1509.

[94] See note 93 *supra* and cases cited therein.

Generally, liability attached only when the court found three factors present. First, the exchange must have had actual knowledge or reason to know of a rule violation; second, the exchange must have subsequently failed to act; third, the failure to act must have been the proximate cause of plaintiff's injury.[95] The *Hughes* court, by effectively extending section 6 negligence liability to positive measures taken by an exchange to remedy a rule violation, significantly broadened the scope of the duty owed under section 6.

III. TOWARDS AN APPROPRIATE STANDARD OF REVIEW

A. *Limitations of a Negligence Standard.*

An appropriate standard for judicial review of exchange obligations under section 6 must effectuate the statutory scheme which depends upon exchange initiative to regulate the industry. Accordingly, a negligence standard as used by the *Hughes* court must be examined with a view toward determining its effect on the self-regulatory framework including exchange-Commission relations. There is a fundamental difference between a negligence standard which evokes a court determination of whether an exchange had actual knowledge or reason to know of rule violations and one which involves a determination of whether the actions taken by the exchange pursuant to a violation were adequate. The first is proper for judicial determination because a readily defined standard is available, one which courts have had considerable experience in dealing with, and one which requires no special knowledge of the securities industry. In contrast, the other approach must take into account such factors as Commission policy and the extent of its knowledge of the facts, exchange rules and past procedures, the interests of the firm which the action is being applied to, its creditors and investors, and the interests of public investors.

By narrowing the scope of inquiry to specifics of the given case a court imposing a negligence standard fails to weigh the impact that such a standard may have on the system of self-regulation devised by Congress. A negligence standard could well destroy the advantages inherent in a self-regulatory system. By focusing on a single aspect of an exchange's duty and attempting to assess the reasonableness of the action taken, a court may not weigh other aspects of industry regulation for which an exchange as the more experienced body had properly accounted. A court simply does not have sufficient knowledge of the dynamics of the securities industry to weigh these factors properly according to a negligence standard and should, therefore, defer to the Commission which not only has such knowledge, but which was expressly created by Congress to oversee the industry.

Moreover, self-regulation has the advantage of having those most expert in the industry responsible for its conduct on a daily

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[95] *See, e.g.*, Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 372 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974); Marbury Management, Inc. v. Kohn, 373 F. Supp. 140, 143 (S.D.N.Y. 1974).

basis.[96] It is psychologically more appealing to the industry to regulate itself than to be regulated by supervisory body.[97] More importantly, self-regulation, by actively involving members of the industry, can generate a moral ethic which could never be legislated.[98]

Additionally, utilization of a negligence standard could potentially interfere with the balance of exchange self-regulation and broad Commission oversight. A scheme of self-regulation, such as Congress created in the securities industry, clearly places an emphasis on exchange initiative and responsibility.[99] To promote these qualities, self-regulatory bodies must be given broad discretion in the enforcement of their rules. If liability is imposed for active measures made in good faith to remedy rule violations, there is little likelihood that an exchange will take the initiative imperative to self-regulation and will promulgate new rules to meet the changing needs of the industry, since to do so would simply create a greater potential liability for failure to enforce new rules adequately. Thus, while the imposition of a negligence standard appears to be a judicial attempt to ensure responsible action on the part of an exchange, it may well have the opposite effect.

Finally, use of a negligence standard to impose liability on exchanges for actions designed to redress rule violations may well interfere with the statutory scheme of self-regulation by causing a disintegration of essential rapport between the Commission and the exchanges.[100] By so circumscribing exchange initiative, a negligence test may force the Commission to play a far greater role in exchange supervision than the Act envisioned. Thus, if the Commission *informally* insists that an exchange issue new rules, as has been the practice in the past,[101] the exchange is likely to resist if faced with a negligence standard for liability. The Commission may be forced to

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[96] Putting aside for the moment questions of motivation and adequate concern for the public interest, persons on the scene and familiar with the intricacies of securities and markets from daily and full-time pursuit of the business can more readily perceive and comprehend some types of problems and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the event, and often must defer decision and action until thorough investigation or study has been completed.

SPECIAL STUDY, *supra* note 75, at 694.

[97] Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROB. 663, 678 (1964).

[98] *Id.* Self-regulation does have limitations. As illustrated in the Commission's SPECIAL STUDY, *supra* note 75 at 695-97, there is a tendency for self-regulators to be complacent, and less than diligent in certain areas.

[99] SPECIAL STUDY, *supra* note 75, at 702.

[100] *Id.* at 723.

[101] *See generally* Note, *Informal Bargaining Process: An analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L. J. 811, 819 (1971). The Commission has only used its authority under § 19(b) twice to alter an exchange rule. *Id.* at 815 n.32. It prefers to use informal bargaining pressure to effectuate desired rule changes. *See generally* 80 YALE L. J. 811 (1971).

use its Section 19 authority to enact rule changes directly. The Commission has attempted to avoid use of these powers so as to minimize unnecessary friction between the two bodies.[102] Consequently, the Commission has chosen to rely on quick, efficient, and informal channels of communication.[103] This may effectively be destroyed if the Commission were unable to immunize an exchange's decision to enforce rule changes which the Commission thought necessary. Thus, a negligence test is not only inconsistent with a statutory scheme geared toward self-regulation, but its continued use may well cause a deterioration of Commision-exchange rapport so necessary to the supervison of the securities industry.

B. *Abuse of Discretion as a Standard of Review*

Since negligence as a standard for review is not appropriate in instances of active rule enforcement, a viable alternative must be sought. Because the same policy considerations apply,[104] an instructive area of examination is the standard of review utilized in rule promulgation. There would appear to be little difference between an alleged section 6 violation for failure to enact adequate rules and one alleging inadequate remedial rule enforcement where the Commission has knowledge of the exchange's actions. The latter simply might be considered an instance of bending the rules, which, in effect, is rule promulgation to fit a particular situation.

When an injured investor has brought suit alleging that an exchange has breached its section 6 duty by failing to promulgate rules or by promulgating inadequate rules, the courts have uniformly dismissed the claim, holding that the investor's only recourse is to request that the Commission, pursuant to section 19(b) authority,[105] alter or supplement exchange rules and practices.[106] Thus in reviewing these claims the courts have uniformly deferred to the judgement of the Commission. For example, in *Carr v. New York Stock Exchange, Inc.*,[107] the court held that the duty to promulgate rules adequate to protect investors, "falls outside the duty owed to plaintiffs."[108] As in *Hughes*, the plaintiffs in *Carr*, were investors in a brokerage firm rather than in securities,[109] but as such would still have fallen under the broad

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[102] *Id.* at 816.

[103] *See generally* 80 YALE L. J. 811 (1971).

[104] For a discussion of these policy considerations see text at notes 108-13 *infra*.

[105] See note 74 *supra*.

[106] *See, e.g.*, Carr v. New York Stock Exchange, Inc., 414 F. Supp. 1292, 1306 (N.D. Cal. 1976); Rich v. New York Stock Exchange, 379 F. Supp. 1122, 1128 (S.D.N.Y. 1974) *rev'd on other grounds*, 522 F.2d 153 (2d Cir. 1975); Marbury Management, Inc. v. Kohn, 373 F. Supp. 140, 144 (S.D.N.Y. 1974); Kroese v. New York Stock Exchange, 227 F. Supp. 519-21 (S.D.N.Y. 1964).

[107] 414 F. Supp. 1292 (N.D. Cal. 1976).

[108] *Id.* at 1299.

[109] *Id.* at 1298.

scope of section 6 protection if they had alleged that the exchange failed to act upon knowledge of a rule violation.[110]

In light of both the Congressional purpose underlying enactment of the Securities Exchange Act—investor protection—and the courts' willingness to imply private remedies to effectuate this intent where an exchange has failed to act,[111] it seems logically inconsistent to hold that the same duty owed to investors for rule enforcement is not owed by an exchange for inadequate rule promulgation. Thus while the courts speak in terms of no duty owed to an investor for inadequate rule promulgation it is more likely that there is a duty owed, but there is also a presumption that this duty has not been breached. Therefore there is no logical inconsistency if it is assumed that because section 6(d) states that the Commission may not grant a registration to an exchange unless there is a determination that "the rules of the exchange are just and adequate to insure fair dealings and protect investors,"[112] courts have treated the granting of a registration to an exchange as a conclusive presumption that the duty to the investor has been met. Indeed, the courts appear willing to assume that implicit in a grant of registration is a Commission determination that the exchange has promulgated adequate rules:

> [I]t does not follow that a rule made by the Exchange under the regulatory eye of the SEC is open to question in the courts. Plainly, determination of whether a rule . . . is adequate or inadequate raises issues calling for the exercise of judgmental factors which are within the special competence of the SEC and outside the conventional experience of judges and juries. Precisely because the SEC possesses expert and specialized knowledge in this field, congress expressly placed the responsibility for resolution of such issues under this comprehensive regulatory scheme on the SEC, not on the courts.[113]

There are numerous advantages to applying an abuse of discretion standard in the review of exchange rule enforcement procedures. First, an abuse of discretion standard more consistently serves the statutory purposes envisioned in self-regulation than does a negligence standard. Secondly, the abuse test will better serve to foster the

[110] See text at notes 83-95 *supra*.

[111] *Id.*

[112] See note 90 *supra*.

[113] Cutner v. Fried, 373 F. Supp. 4, 8 (S.D.N.Y. 1974). The case dealt with promulgation of rules governing specialists, pursuant to § 11(b), 15 U.S.C. § 78K(b) (1970). The same policy considerations of deference to Commission judgment in the rule promulgation area should apply equally as well to the rule enforcement area. The court in *Hughes* found that the Commission could have acted under § 19(b). 534 F.2d at 172. This determination should have led the court to conclude that the proper remedy for alleged violations of positive rule enforcement measures lay with the Commission. The failure of the *Hughes* court to defer to the Commission thus had the effect of usurping the Commission's authority in a way that comes close to judicial rulemaking.

initiative necessary to self-regulation. Exchange initiative thus decreases the need for impetus from the Commission, by maintaining an informal relationship between the two bodies, thereby reducing the potential for friction implicit in a negligence test. More importantly, an abuse test permits the judiciary the necessary latitude in reviewing exchange action. By allowing a court to scrutinize exchange actions to see if they are arbitrary or capricious, the court is relieved of the responsibility of trying to independently assess the reasonableness of exchange decisions.

Application of an abuse of discretion standard when a court is reviewing remedial measures taken by an exchange upon knowledge of rule violations has drawn support not only from practical policy considerations but from precedent as well. In *Rich v. New York Stock Exchange*,[114] the Exchange found a broker-dealer in violation of Rule 325.[115] After studying the problem, the Exchange proposed a merger with another broker-dealer.[116] Upon the firm's failure and forced liquidation, the plaintiff-investor brought suit alleging breach of a section 6 duty due to the Exchange's failure to enforce the rule.[117] In granting summary judgment in favor of the Exchange, the *Rich* court gave a broad interpretation to the legislative standard of conduct set out in section 6(b). "The duty of the Exchange under section 6 to enforce compliance with its rules 'so far as within its powers' must be evaluated reasonably. . . . The Exchange's supervision need not be fluoroscopic, ..."[118] While "reasonably," appears to connote a negligence test, the court seemingly afforded a great deal of discretion to Exchange judgment. It did not examine the details of the proposed remedial action but rather based its determination solely on the fact that Exchange action had been in accordance with successful past procedures for rescuing troubled firms.[119] The court apparently reasoned that the Exchange action was not arbitrary and was, in fact, rationally based on Exchange policy. While not specifically enunciating it as such, the *Rich* court thus appears to have applied an abuse of discretion standard in assessing Exchange liability, and in so doing seems to have avoided the necessity of attempting to weigh independently the sufficiency of the action taken.

Further support for applying an abuse of discretion standard to review of exchange enforcement action may be inferred from the fact that abuse of discretion is the standard which typically has been used by the courts when reviewing Commission action.[120] When a decision

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[114] 379 F. Supp. 1122 (S.D.N.Y. 1974), *rev'd on other grounds*, 522 F.2d 153 (2d Cir. 1975).

[115] *Id.* at 1125. Rule 325 is the same rule which the *Hughes* complaint was based on. See note 7 *supra* and accompanying text.

[116] 379 F. Supp. at 1124.

[117] *Id.*

[118] *Id.* at 1126.

[119] *Id.* at 1127.

[120] *See, e.g.*, Don D. Anderson & Co. v. Securities & Exchange Comm'n, 423 F.2d 813, 817 (10th Cir. 1970); Associated Sec. Corp. v. Securities & Exchange Comm'n, 293

entails the evaluation of a situation such as existed in *Hughes*, the judgment of what is in the best interests of all parties, especially the public investors, should be left to the Commission, as the body charged with regulating the securities industry.[121] This is accomplished by limiting judicial review to a determination of whether the action was so arbitrary, or unsupported by the facts that the Commission abused its discretion. This deference by the courts to the Commission as the agency created by Congress to protect the interest of investors is also a recognition of the Commission's greater expertise:

> So long as the Court finds that the Commission, however inexpertly or imperfectly, is effectuating the intent of the statute and that its regulations, however burdensome, are so directed, within statutory and constitutional limits it may not substitute its judgment for the more informed and expert judgment of the Commission or pronounce upon its wisdom for it . . . has neither the technical competence nor legal authority to do so . . . .[122]

While judicial deference to a governmental agency is theoretically different than deference to a private body, there are cogent reasons for allowing an exchange virtually the same discretion in rule interpretation and enforcement. Congress gave the exchanges the primary role of policing the industry.[123] In addition, because the Commission itself has deferred enforcement in many areas to exchange self-regulation, an exchange acts in many respects as a quasi-

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F.2d 738 (10th Cir. 1961). The *Anderson* case involved the sanctioning of a member of the National Association of Securities Dealers, Inc. (NASD), by the Commission. The Commission acted after finding a violation of NASD's net capital rule. 423 F.2d at 815. Petitioner claimed that another rule, which requires that a *prima facie* violation of the net capital rule is made by showing no market for the securities (claimed by the petitioner to qualify under the net capital rule), violates due process by creating an impermissable presumption. *Id.* at 816-17. The court found that the statutory presumption created by the Commission's rule was a permissible exercise of its discretion, "if there is a rational connection between the facts proved and the ultimate fact presumed." *Id.* at 817. Associated Sec. Corp. v. Securities & Exchange Comm'n, 293 F.2d 738, 741 (10th Cir. 1961). The *Associated Securities* case involved revocation of the license of a broker-dealer for committing fraud on its customers by selling stock at a price not reasonably related to the prevailing market price. 293 F.2d at 740. The court found that the determination of market price of a security called for an exercise of Commission expertise. *Id.* at 741.

> The balancing of private detriment against public harm requires the fair and proper exercise by the Commission of its discretionary powers. The evaluation of facts and the exercise of judgment for the protection of investors dealing in over-the-counter securities is a function assigned by Congress to the Commission rather than the courts and the exercise by the Commission of its discretionary powers will not be upset by the courts except for cogent reasons. An examination of the entire record establishes that the revocation of the Associated registration was based on substantial evidence and that the Commission did not abuse its discretion.

[121] *See id.*

[122] Perlman v. Timberlake, 172 F. Supp. 246, 254 (S.D.N.Y. 1959).

[123] See text at notes 75-79 *supra.*

governmental body.[124] Thus, since the exchanges effectively share with the Commission the responsibility of regulating the industry, the deference paid to Commission expertise is similarly relevant to exchange expertise, and "[t]he courts should be reluctant to substitute their hindsight judgment for those responsible for maintaining the integrity of the industry . . . ."[125]

Courts, then, have deferred to Commission judgment when its decision has been based on expertise uniquely within the Commission's sphere.[126] On the other hand, when a Commission decision turns on an assessment which a court is highly capable of determining,—such as the validity of witness testimony,—there is no need to bow to Commission judgment.[127] This procedure would serve equally well for review of alleged section 6 violations by an exchange. When the claim alleges that an exchange had knowledge or reason to know of a rule violation, a court has a readily defined standard and the finding should not necessitate any special knowledge of the securities industry; however, when the alleged violation is for inadequate remedial action taken by an exchange pursuant to a rule violation, no readily defined standard is available to a court and a determination of liability involves an intimate knowledge of the industry which a court is unlikely to possess. Therefore, a court in determining liability should limit itself, as the court in *Rich* effectively did,[128] to a finding of whether the particular decision was so arbitrary that the exchange abused its discretion.

IV. THE PROPER FORUM OF REVIEW AND THE PRESUMPTION THAT THE EXCHANGE HAS NOT ABUSED ITS DISCRETION.

The proper forum for reviewing an allegation of negligence in remedial action taken by an exchange pursuant to a rule violation should be the Commission.[129] Moreover, to the extent that the Commission has reviewed exchange action and given its approval, a *presumption* should arise that the exchange has not abused its discretion. Support for both these propositions is found in the evaluation of

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[124] See text at notes 70-75 *supra*.

[125] J.R. Williston & Beane, Inc. v. Haack, 387 F. Supp. 173, 181 (S.D.N.Y. 1974); *accord*, Zuckerman v. Yount, 362 F. Supp. 858, 863 (N.D. Ill. 1973); *but see* Arneil v. Ramsey, 414 F. Supp. 334 (S.D.N.Y. 1976). In *Arneil* the court denied an Exchange motion for summary judgment for an alleged § 6 violation for failure by the Exchange to require "knowledgeability letters." *Id.* at 342. The Exchange argued that these letters were not mandatory and that the decision to require them was always made on an ad hoc basis. *Id.* The court held the Exchange to a duty to make these decisions consistent, and in a manner protective of investors. *Id.* Thus, the court appears to have substituted its hindsight judgment for that of the Exchange.

[126] See text at note 122 *supra*.

[127] Klopp v. Securities & Exchange Comm'n 427 F.2d 455, 458 (6th Cir. 1970).

[128] See text at notes 114-19 *supra*.

[129] "[T]he Special Study is of the view that primary jurisdiction in this area should reside in the Commission." SPECIAL STUDY, *supra* note 75, at 701.

Silver v. New York Stock Exchange,[130] contained in the *Special Study of Securities Markets* undertaken by the Commission. *Silver* involved two non-Exchange members who had obtained wire service from the Exchange. Exchange rules permitted it to stop this service at any time.[131] After seven months the Exchange discontinued service without notice or reason.[132] The Supreme Court held that the Securities Exchange Act of 1934 did not immunize the Exchange from antitrust liability in this instance.[133]

Crucial to the Court's reasoning in *Silver* was the inability of the Commission to review Exchange enforcement action.[134] The question of exchange liability where the Commission did have authority to act, as in *Hughes*, was not answered. The *Hughes* court distinguished the role of the Commission in *Silver* from its role in the instant case.[135] The *Silver* court had to reconcile two conflicting bodies of law, with the governmental regulatory agency having jurisdiction only to request rule changes, but possessing no authority to review action taken. *Hughes* dealt only with the weight to be accorded Commission action:

> When the exchange action at issue involves one of the categories listed in Section 19(b), the options open to the Commission are greater, and its action or inaction should be accorded greater weight. Applying this approach to the instant case, we find that Section 19(b) explicitly gives the Commission the power to initiate rule changes involving "safeguards in respect of the financial responsibility of members," which is precisely the subject at issue here.[136]

The court found "some indication of tacit approval from the lack of Commission action."[137] While properly distinguishing *Silver* from the case before it, the *Hughes* court concluded that even Commission "approval" when it also had authority to act[138] would not immunize an exchange from liability.[139] *Silver* does not mandate this result as it dealt with a situation when the Commission had no authority to act. Moreover the decision in *Rich* appears to reach an opposite conclusion from *Hughes*.[140] Summary judgment in *Rich* was granted to the Exchange on a showing that its action was similar to that which had been previously acknowledged by the Commission with approval.[141] This

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[130] 373 U.S. 341 (1963).
[131] *Id.* at 344.
[132] *Id.*
[133] *Id.* at 365.
[134] *Id.* at 357-58.
[135] 534 F.2d at 172.
[136] *Id.*
[137] *Id.*
[138] See text at note 136 *supra*.
[139] *Id.* at 174.
[140] *See* 379 F. Supp. at 1127.
[141] *Id.* "Its procedure was in accordance with practices the SEC has acknowledged to be proper and effective means of salvaging firms facing financial ruin." *Id.*

reasoning supports the proposition that the proper forum for review of exchange action is the Commission[142] and, to the extent that the Commission has approved exchange action, this should create a presumption that the exchange has not abused its discretion. A contrary finding would place exchanges in an untenable position—"either to submit themselves to a form of strict liability for the potential risks inherent in the type of protective scheme devised to protect [a member] or to forego equally important obligations—legal and ethical—to other members."[143] It also would interfere with the statutory scheme of exchange self-regulation with Commission oversight by having the court place itself in the position of the reviewing forum rather than the Commission.

This presumption should have been applied to the Commission's actions in *Hughes*. The Commission's knowledge of Dempsey's financial problems was amply documented. The Exchange kept the Commission informed of Dempsey's situation.[144] In addition, the Commission expedited the registration of the subordinated stock with knowledge of its use by Dempsey.[145] Finally, when the Exchange lifted its restrictions, the Commission lifted its ban on further underwritings by Dempsey,[146] thus suggesting that it viewed Dempsey's position as viable. This level of involvement by the Commission and its apparent authority to take affirmative action under section 19(b)[147] led the *Hughes* court to conclude that there was "tacit approval"[148] of Exchange action by the Commission. This, in turn, seemingly should have led to the further conclusion that this "tacit approval" created a presumption that there was no abuse of discretion.

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[142] This was also the conclusion of the SPECIAL STUDY *supra* note 75, at 707:

> If self-regulation is to function effectively and with due regard for *all* aspects of the public interest, including the interest in vigorous self-regulation, the forum for review of self-regulatory action should be the agency already established as the official, expert guardian of the public interest in the field of securities; i.e., the Commission. With its broad responsibility and concern for the entire area, it is in the best position to comprehend and reconcile—in the first instance and subject to judicial and congressional oversight of its own activities—the diverse factors and considerations that may constitute or bear upon the total public interest in the manifold and complex circumstances where the question may arise. This is true of questions of competition and all other aspects of the public interest, as well as questions of reconcilement of private interests. For an orderly and coherent regulatory scheme, with self-regulation playing its intended role, needed governmental oversight ought to be fragmented as little as possible. This is, indeed, one of the basic roles of a specialized agency created to deal with a particular industry affected with a public interest.

[143] Hughes v. Dempsey-Teleger & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,546 (C. D. Cal. 1973).

[144] *Id.* at 94,545.

[145] 534 F.2d at 164.

[146] *Id.*

[147] See text at note 136 *supra*.

[148] 534 F.2d at 172.

V. THE ABUSE OF DISCRETION STANDARD AS APPLIED TO THE *HUGHES* FACTS.

While the *Hughes* court concluded that there was "tacit" Commission approval, the district court made an explicit finding that there was neither Commission approval nor disapproval.[149] Where there is a finding that the Commission has neither approved nor disapproved exchange action "officially" or "tacitly," either because it had no authority to do so or because it had insufficient knowledge of exchange actions, no presumption should be created. Therefore, the courts should simply apply an abuse of discretion test. If the Exchange's actions in *Hughes* were measured by an abuse of discretion standard without the presumption that there was an abuse, it appears that the Exchange did not violate its section 6 duty to Hughes. The imposition of restrictions by the Exchange reflected an obvious concern that Dempsey was in trouble. Suspension of the firm, however, would protect neither its customers nor the other broker-dealers which the Exchange was obligated to protect.[150] With so speculative a market, the Exchange feared that if the public learned that Dempsey had been suspended, an investor panic would result.[151] The subsequent lifting of restrictions was the Exchange's response to what it saw as a change in Dempsey's situation. Dempsey's problems appeared to be twofold: operational difficulties and net capital deficiency. The net capital problem was to be cured by the subordinated loans. With receipt of these funds, the plan to once again make Dempsey a profit-making organization required removal of the restrictions.[152] Many of Dempsey's operational problems appeared to have been solved, at least on the surface, by the time the Exchange and the Commission removed their restrictions. Dempsey had reduced its branches by 50%; all the accounting and operational control had been centralized.[153] Top management, which was thought to be the balance of Dempsey's operating problems, had been replaced.[154] Comparable corrective procedures had worked for the Exchange on other occasions.[155]

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[149] Hughes v. Dempsey-Teleger & Co., Inc. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,541 (C.D. Cal. 1973). The district court balanced the involvement of the Commission against the Exchange's control over the barameters by which the accounting positions of the firms could be determined and the Exchange's decision to withhold the availability of its trust fund should the Commission place Dempsey in receivership. This latter point, the court concluded, forced the Commission into inaction. *Id.* The Ninth Circuit in *Hughes* discounted these factors in finding "tacit approval." 534 F.2d at 172.

[150] *See* Hughes v. Dempsey-Tegeler, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,544 (C.D. Cal. 1973).

[151] Id. at 94,532.

[152] Brief for Appellee at 72, Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156 (9th Cir. 1976).

[153] *Id.* at 70-71.

[154] *Id.* at 70.

[155] *Id.*

Thus, when the restrictions were lifted it appeared that Dempsey was fully capable of becoming once again a viable operation. The problem lay in the fact that the Exchange, and probably the Commission as well, remained unaware of the total disarray of the bookkeeping of many of the member firms.[156] There was simply a mountain of paper which the firms were unable to handle properly. This "paper crunch" highlighted a structural weakness in the securities industry which was unanticipated and which the industry was incapable of dealing with immediately.[157] Furthermore, the paperwork crises led to inaccurate recordkeeping which resulted in large losses.[158] The combined effect of this, and a sudden market recession[159] probably caused the collapse of many of the thinly capitalized firms such as Dempsey.[160] The Exchange, however, continued to view the crisis as a temporary one, with the firms needing time to adjust properly.[161] This miscomprehension of the problem as simply one of adjustment apparently was shared by the Commission when it lifted its underwriting ban on Dempsey after Dempsey complied with the net capital rule.

The removal of restrictions on Dempsey should therefore be interpreted as reflecting an Exchange determination that Dempsey's position had changed. This conclusion is supported by Dempsey's receipt of the subordinated loans, Dempsey's operational changes, and the Commission's lifting of the underwriting restriction. Viewed in light of these facts and in light of the Exchange's erroneous but good faith belief that the continued operational difficulties were merely temporary rather than structural, the Exchange's action in lifting its restrictions on Dempsey was not arbitrary. The adjustment period upon which the Exchange relied was unavailable to Dempsey since the unexpected market recession coincided with the Exchange's removal of its restrictions.[162]

In view of the fact that Dempsey's demise followed so rapidly the market drop and that the removal of the restrictions, if negligent at all, would probably have been gradual in effect, the conclusion might be drawn that Dempsey's failure was not the immediate result of the Exchange's action. However, the finding of waiver[163] thus relieved the *Hughes* court of the difficult task of finding that the

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[156] SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 231, 92d Cong., 1st Sess. 13 (1971). "The back offices of many a broker-dealer resembled a trackless forest." *Id.* The author would like to thank Mr. Bailey Smith of *Hoppin, Watson, Inc.* for his invaluable insight into market conditions during this period.

[157] *Id.* at 28-29.

[158] *Id.* at 13-14, 28-29.

[159] See note 24 *supra*.

[160] SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, *supra* note 156, at 29.

[161] *Id.* at 29.

[162] 534 F.2d at 164-65.

[163] *Id.* at 174-75.

Exchange's action was the proximate cause of Hughes' loss—an element which had been required under the *Baird* line of cases.[164] In light of the district court's finding that the Exchange did not and was not required to foresee the sudden and sharp decline of the stock market, particularly in the King stock, the removal of the restrictions may not have caused the harm. Thus, if the *Hughes* court had not barred recovery on a theory of waiver, it may have been forced to bar it for lack of proof on the issue of causation.

VI. THE 1975 AMENDMENTS

In amending the Securities Exchange Act,[165] Congress has apparently adopted a negligence standard with respect to exchange rule enforcement. Section 19(g)(1) states that an exchange must comply with its own rules "absent reasonable justification or excuse."[166] Thus, an exchange appears to be subject to liability for failure to strictly enforce its rules and may raise as an affirmative defense, that it was not negligent. Yet, this provision must be read in conjunction with section 19(g)(2),[167] which provides that the Commission, by rule "may relieve any self-regulatory organization of any responsibility under this chapter to enforce compliance [with its rules]." Section 19(g)(2), then, appears to be Congress' response to the dilemma which the *Hughes* negligence standard places an exchange in.[168] As recognized by the district court in *Hughes*, a negligence standard places an exchange in the impossible position of risking liability for the types of measures taken in *Hughes* or foregoing its legal and ethical responsibilities to the firm in trouble and the other members of the exchange community.[169] This inflexibility is not consistent with the broad discretion inherent in self-regulation.[170] However, by allowing the Commission to relieve an exchange of its duty to strictly enforce its rules, this section remains

[164] See text at notes 93-95 *supra*.

[165] Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

[166] 15 U.S.C. § 78s(g)(1) (Supp. V 1975). This section provides:

> Every self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and (subject to the provision of section 78q(d) of this title, paragraph (2) of this subsection, and the rules thereunder) absent reasonable justification or excuse enforce compliance . . .

[167] 15 U.S.C. § 78s(g)(2) (Supp. V 1975). This section provides:

> The Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of this chapter, may relieve any self-regulatory organization of any responsibility under this chapter to enforce compliance with any specified provision of this chapter or the rules or regulations thereunder by any member of such organization or person associated with such a member, or any class of such members or persons associated with a member.

[168] *See* S. REP. NO. 75, 94th Cong., 1st Sess. 133 (1975), *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 613, 744.

[169] See text at note 143 *supra*.

[170] Hughes v. Dempsey-Tegeler & Co., Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133, at 94,546 (C.D. Cal. 1973).

consistent with the self-regulatory goal of exchange initiative in developing and enforcing rules to meet the industry's changing needs.

The practical effect of these provisions will likely be to give the exchange an opportunity to place the decision-making responsibility in the lap of the Commission if an exchange wants to bend its rules to save a member firm, as was attempted in *Hughes*. Apparently, if the Commission "relieves" the exchange of its rule enforcement duty, it will, contrary to the reasoning of the *Hughes* court,[171] effectively immunize the exchange from liability. If the Commission does not "relieve" the exchange then a negligence standard will be imposed. Still, the use of this standard will not be inconsistent with the use of an abuse of discretion standard suggested for cases arising prior to the effective date of the amendment, where there is either a finding of non-involvement or approval by the Commission.

The Amendments thus provide an opportunity for the Commission to appraise itself of the situation, and if it sees fit, "consistent with the public interest," to grant relief and immunize the exchange. Indeed, the risk inherent in the *Hughes* negligence standard seems to dictate that an exchange would always seek to avail itself of this "immunization" opportunity. Thus, it would appear that in the future there will always be Commission opportunity to approve proposed exchange "rule-bending" policies. Accordingly, a failure by the Commission to immunize the exchange should be read as a disapproval of exchange policy. This "disapproval" by the Commission should permit a court to draw the inference that the exchange was negligent. If an exchange acts in the face of Commission disapproval and decides to bend its rules, it has *knowingly* assumed the risk of liability. Thus, by providing a mechanism for Commission approval prior to a court's determination of liability, the Commission remains the proper forum for review of exchange action and the statutory scheme is not disrupted. Should the Commission "relieve" the exchange under section 19(g)(2), this action is reviewable in the courts under section 25.[172] The court's standard of review here is whether in promulgating the rule relieving the exchange of its rule enforcement responsibility the Commission action was "arbitrary, capricious, [or] an abuse of discretion . . . ."[173] This is the same standard which this article has suggested should apply to exchanges in cases arising out of fact situations which occurred prior to the 1975 Amendments.

In addition to section 19(g), other amendment provisions give the Commission increased authority to regulate directly the securities markets. The overall purpose of the amendments is to ensure that the Commission play a much greater role and provide leadership to the

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[171] 534 F.2d at 174. See discussion in text at notes 138-147 *supra*.
[172] 15 U.S.C. § 78y (Supp. V 1975).
[173] Id. at § 78y(b).

industry.[174] To help effectuate this purpose, sections 19(c) and 19(d) provide direct review of exchange disciplinary action[175] and authority to "abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary . . . ."[176] The Commission is also given the authority to directly impose restrictions on an exchange member such as the ones placed on Dempsey by the Exchange.[177] These provisions, by giving the Commission direct regulatory authority, decrease the initial necessity of having an exchange make discretionary decisions. By providing for greater Commission action, these provisions are consistent with section 19(g)'s negligence standard. This standard deters excessive exchange action and these provisions provide for direct Commission involvement to fill this gap. Thus an abuse of discretion standard is no longer necessary after the implementation of these amendments.

CONCLUSION

The willingness of the *Hughes* court to impose a negligence standard upon exchange action places a securities exchange in a precarious position. The court's additional indication that Commission approval of exchange remedial action would not immunize an exchange from liability further heightens this insecurity. Such a judicially imposed negligence standard fetters the discretion of a stock exchange to an impermissible degree. A securities exchange must be given wide latitude in interpreting and enforcing its own rules, if it is to fulfill its statutory function. As a self-regulatory body, it has been given the primary role for policing the industry. Only by allowing an exchange broad discretionary judgment or by allowing it to seek immunization from the Commission for crucial determinations, will it be able to take the initiative in regulating an industry as complex as the securities market. This is especially true when exchange actions have received Commission approval. As the governmental body given the primary responsibility for overseeing the entire securities industry, the courts should defer to Commission judgment rather than risk interference with the statutory scheme. However, when the Commission has disapproved of exchange action, the court may properly find the exchange negligent. The rationale of the *Hughes* decision is obviously one of investor protection. Yet, by so circumscribing exchange discretion, the court fosters rigidity in exchange action which will result in a net harm to the investor. In practical terms, an exchange, faced with potential liability, will in all probability be forced to suspend a member firm in violation of exchange rules rather than risk using discretion in

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[174] S. REP. NO. 75, 94th Cong., 1st Sess., 2, 33 (1975), *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 613, at 615, 645.

[175] 15 U.S.C. § 78s(d) (Supp. V 1975).

[176] Id. at § 78s(c). This section replaces the 12 specific areas in which the Commission could add to rules under previous § 19(b).

[177] Id. at § 78s(h)(1).

the interpretation and enforcement of those rules to bring the firm into compliance. In such a situation, the ultimate losers are the firm and its investors. This surely was not the intent of Congress when it passed the Securities Exchange Act. The passage of the 1975 Amendments appears to replace the balance between necessary exchange discretion and Commission responsibility which the *Hughes* standard would have upset.

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