UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

NORMAN L. HARWELL, et al.,	:	
Plaintiffs,	:	
v.	:	CIVIL ACTION NO. 66-92-SA
GROWTH PROGRAMS, INC., SUPERVISED INVESTORS SERVICES, INC., and NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,	:	
Defendants.	:	

MEMORANDUM OF SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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NORMAN L. HARWELL, et al., Plaintiffs, v. GROWTH PROGRAMS, INC., SUPERVISED INVESTORS SERVICES, INC., and NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., Defendants.	CIVIL ACTION NO. 66-92-SA

MEMORANDUM OF SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

The Securities and Exchange Commission, with leave of the Court, submits this memorandum of law, amicus curiae, in order to present its views upon certain questions of law arising under the Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq., the resolution of which would seem to be essential to a ruling on the cross-motions for summary judgment filed herein. The questions raised pertain largely to Section 15A of that Act, 15 U.S.C. 78o-3, sometimes referred to herein as the Maloney Act. 1/

1/ In addition to adding Section 15A to the Securities Exchange Act, the Maloney Act, adopted in 1938, amended several other provisions of the Securities Exchange Act.

STATEMENT OF THE CASE

This action, which this Court on December 7, 1967, determined may be maintained as a class action, is essentially an action for damages and for the resumption of certain contractual arrangements (whether by injunctive or declaratory relief or by specific performance), based on alleged breaches of contract and violations of the federal antitrust laws.[2/] The plaintiffs are all purchasers of single-payment contractual plans for the accumulation of shares of Technology Fund, Inc. (the "Fund").[3/] The defendants are Growth Programs, Inc., the sponsor and sales agent of the Fund's single-payment contractual plans; Supervised Investors Services, Inc., the Fund's principal underwriter and management company; and the National Association of Securities Dealers, Inc. ("NASD"), a voluntary association of securities dealers and the only "national securities association" registered with the Commission under Section 15A of the Securities Exchange Act. Giving rise to the causes of action asserted herein is an interpretation of the NASD's Rules of Fair Practice, entitled "Interpretation with Respect to Contractual Plan Withdrawal and Reinstatement Privileges," the purpose of which was to eliminate a practice whereby holders of contractual plans

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2/ With respect to the breach of contract allegations, jurisdiction is invoked on the basis of diversity of citizenship under 28 U.S.C. 1332; with respect to the antitrust allegations, jurisdiction of this Court is invoked under Sections 1, 2, 7, 15, 22, and 26 of Title 15 of the United States Code.

3/ This open-end investment company was formerly called Television-Electronics Fund, Inc.

Open-end investment companies are sometimes referred to herein as "mutual funds" or "funds."

of open-end investment companies were permitted by certain members of the NASD to speculate in a manner disadvantageous to fellow shareholders of these companies and to the companies themselves.

According to the allegations of the complaint, commencing largely in the late summer and fall of 1965, plaintiffs made substantial investments in single-payment contractual plans sponsored by the defendant, Growth Programs, Inc., for the purchase of shares of the Fund, each of which was evidenced by a contract between the sponsor, the custodian bank, and the investor. Each plan contained a withdrawal-and-reinstatement privilege (referred to in the complaint as an "in and out" and "stop-loss" privilege). This gave the investor the right for a period of thirty years from the date of his original investment in the Fund to convert up to ninety percent of the market value of his shares into cash without the payment of any additional brokerage commission and, thereafter, at any time the investor might wish, the right to reinvest the same amount of cash in shares of the Fund at the then net asset value without the payment of a further sales charge. The sole express limitation on this right appears to have been a requirement that shares involved in such withdrawal or liquidation have

a net asset value of at least fifty dollars.[4/]

4/ The pertinent portion of the Fund's Prospectus, dated April 30, 1965, stated:

> "(3) Partial Withdrawal Without Termination:
>
> "At any time after purchasing a Single Investment Program, the Programholder may, without terminating his Program, withdraw part of his Fund Shares or direct the Custodian to liquidate part of his Fund Shares and remit the net proceeds, provided that the Shares involved in such withdrawal or liquidation have a net asset value of at least $50 and do not constitute more than 90% of the Fund Shares in his account. Where a partial liquidation has been effected, the Programholder may at any time restore in cash up to the same dollar amount so received by him and have it applied to the purchase of Fund Shares at their then net asset value." (Chorn Deposition, Plaintiffs' Exhibit 78A, p. 4.)

Each plaintiff's contract contained the following provisions:

> "(e) Partial Withdrawal Without Termination:
>
> "At any time after the issuance of this Program, the Programholder may without terminating this Program, withdraw part of his Fund Shares, provided such withdrawal shall involve not less than $50.00 of liquidating value and not more than 90% of the Fund Shares standing to his account.
>
> * * *
>
> "If the Programholder has made a partial withdrawal and caused Fund Shares to be liquidated and the proceeds remitted to him, he may at any time thereafter pay to the Custodian, in cash up to the same dollar amount received by him in connection with such partial withdrawal and liquidation and have the same applied to the purchase of Fund Shares at their then net asset value. If the Programholder has made a partial withdrawal and received certificates for Fund Shares, he may, at any time thereafter, restore in kind up to the same number of Fund Shares so withdrawn." (Chorn Deposition, Plaintiffs' Exhibit 1, p. 2.)

Repeated exercise of this privilege has been facilitated by various arrangements, both formal and informal. The prospectus pursuant to which the single-payment contractual plans were purchased established that:

1. the purchaser could give instructions for withdrawals and reinstatements by telephone or wire;
2. such instructions could be given through a securities dealer;
3. the price at which such withdrawals (except in the event of a general decline in security prices) and reinstatements were to be effected would be the net asset value of the underlying mutual fund shares at the time the telephone or wire instructions were received.

(Chorn Deposition, Plaintiffs' Exhibit 78-A, p. 2.)

The original purpose of withdrawal-and-reinstatement privileges in contractual plan contracts was to preserve investments--particularly of shareholders of modest means--in contractual plans for the periodic accumulation of mutual fund shares. As explained by the NASD:

> "The withdrawal and reinstatement privilege was designed to permit an investor faced with a genuine financial emergency to withdraw a substantial portion of his investment and later to replace the money (i.e., repurchase shares) without paying an additional sales charge. The convenience was aimed at preserving the planholder's investment, eliminating the need for borrowing on certificates or liquidating his account in an emergency. It originated with contractual plans of the periodic-payment type, where the proportionately higher 'front-end load' characteristic of such plans would impose an unusually severe burden on a planholder forced to liquidate to obtain emergency funds.
>
> "Single-payment contractual plans were set up within the same framework as periodic-payment contractual plans and the withdrawal and reinstatement privilege was carried over to this method of acquiring investment company shares.

> "For many years the withdrawal and replacement privilege was used sparingly and for emergencies, as contemplated." CCH NASD Manual ¶5261 (1967).

Recently, however, a number of securities dealers and mutual fund sponsors commenced encouraging investors to buy mutual fund shares through contractual plans in order to use the withdrawal-and-reinstatement privilege for speculative purposes. Increasing involvement of segments of the securities industry in the execution of this type of privilege led to the development of a practice whereby the withdrawal-and-reinstatement privilege was exercised through operation of a power of attorney under which a securities dealer or an associated person would be appointed to act as the attorney and, in effect, agent for the programholder. Also, custodian banks, in an apparent effort to cope with the quantity and frequency of withdrawals and reinstatements, evolved a practice whereby they would merely hold checks representing the proceeds from withdrawals, or merely credit the account of the investor with such proceeds, thereby enabling the investor immediately to apply the same funds in repurchasing or reinstating such previously withdrawn shares in his contractual plan account. (Third Amended Complaint, Exhibit D, p. 2.)

The spread of this practice gave rise to a problem summarized in the Report of the Securities and Exchange Commission on Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong.,

2d Sess. 304-305 (1966):

> "In recent years there appears to be a growing use by speculatively oriented investors of withdrawal and reinvestment privileges in connection with single payment plan certificates issued by contractual plan companies . . . . [T]he extensive use of single payment plan withdrawal and reinvestment privileges by a relatively few speculatively minded investors could seriously circumscribe at critical times the exercise of managerial discretion in the interest of the large majority of shareholders who have long-term investment objectives. It creates substantial questions of fairness to the large majority of mutual fund shareholders who make their investments and pay a continuing fee to obtain the unencumbered investment judgments of professional management, not of fellow shareholders interested in speculation. Moreover, it is the entire body of shareholders in a fund, rather than these speculators alone, who bear the increased brokerage costs that are incurred."

By letter and attached memorandum, dated March 10, 1966, the Association of Mutual Fund Plan Sponsors, Inc., a trade organization of sponsors of contractual plans, of which the defendant, Growth Programs, Inc., was a member, admonished all sponsors of plans for the accumulation of mutual fund shares from knowingly participating in such

> "abuse of the partial withdrawal privilege by holders of Single Payment Plans by withdrawal of cash (up to 90% of the value of their fund shares) for reasons completely at variance with the purpose of this provision . . . ."

The letter also stated:

> ". . . In these instances, the withdrawal privilege served as a facade that permitted holders (and dealers acting in their behalf) to ride the "up and down" sides of the market repeatedly, without cost. Such practice is an abuse of the intended purpose of the withdrawal privilege.
>
> ". . . [D]ealer encouragement given to such abuse of this privilege could be considered a violation of the principles imposed by the [NASD's] Rules of Fair Practice which, if known to and permitted by the Plan Sponsor, could involve both dealer and sponsor in disciplinary action."

(Chorn Deposition, Plaintiffs' Exhibit 115, pp. 2,3.)

Specifically, cash withdrawn through repeated exercise of the withdrawal-and-reinstatement privilege was being used, in effect, to play the short swings of the stock market. In this regard, the NASD has succinctly observed the methods employed as well as their likely by-products:

> "If a planholder believes, or his dealer leads him to believe, that the market is due for a downturn, he may withdraw 90 percent of his account in cash. Then if the market goes down, the investor or his dealer will, at a point believed to be the bottom of the downturn, replace the withdrawn cash with the fund underwriter, thus acquiring more shares of the underlying fund than the investor redeemed, and at no sales charge. The planholder can continue this practice as often as he or his dealer thinks the short swings in the market can be predicted.
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> * * *
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> "Reinstatement sales alone, i.e., replacement of cash previously withdrawn, in May, 1966, are estimated [industry-wide] to have amounted to $100,000,000.
>
> "One particular investment company underwent a turnover equivalent to 25 percent of its entire assets during a recent six-month period, as a result of planholders withdrawing and putting back cash.
>
> "Obviously, this growing practice can cause severe hardships and expense to the underlying investment company and its shareholders by subjecting the investment company to higher than normal redemptions which, in turn, can force management either to liquidate portfolio securities to meet the demand for cash or force the fund to maintain a substantial cash or liquid position without regard to the investment objectives of the fund. In addition, the practice can result in a form of trading against the fund and may result in substantial dilution of the interest of investors in the fund both those not using the withdrawal and reinstatement privilege and those using the privilege, at least to the extent of their holdings remaining in the fund." CCH NASD Manual ¶5261 (1967).

The growing magnitude of this problem was brought by the NASD to the attention of the Commission's staff in the early spring of 1966, and it concurred in the NASD's view that corrective action was required (Ratzlaff Deposition, pp. 17-18, 20). Various approaches, including action by the Commission itself, were explored (Ratzlaff Deposition, p. 21). It was ultimately determined that the NASD would handle this situation by publishing an interpretation of Article III, Section 1, of its Rules of Fair Practice, which section states:

> "A member in the conduct of its business shall observe high standards of commercial honor and just and equitable principles of trade." CCH NASD Manual ¶2151 (1967). 5/

The NASD was advised by the Commission on July 18, 1966, that it "could proceed with the issuance and publication" of its proposed interpretation, which reflected various suggestions of the Commission's staff. 6/

Accordingly, on July 22, 1966, the Board of Governors of the NASD, pursuant to express authority in the NASD by-laws to make and issue interpretations of the NASD's Rules of Fair Practice, 7/ issued a formal "Interpretation with Respect to Contractual Plan Withdrawal and

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5/ This rule was adopted by the NASD in 1939 and accepted by the Commission in that same year, at the time it approved, as being consistent with the statute, the NASD's application for registration. In the Matter of Application by National Association of Securities Dealers, Inc., for Registration as a National Securities Association, 5 S.E.C. (1939). Section 15A(b)(8) provides that the Commission could not register a national securities association unless the rules of such association were designed, inter alia, ". . . to promote just and equitable principles of trade . . . ." The rule has remained unchanged throughout the years.

6/ Pursuant to the Commission's minute in this matter, the NASD was further advised that consideration should be given to indicating in the proposed interpretation that it was applicable to other redeemable shares issued by investment companies, as well as contractual plans. This suggestion was adopted.

7/ CCH NASD Manual ¶1402, ¶1503 (1967).

Reinstatement Privileges," effective August 1, 1966, as to all such privileges, regardless of when the contractual plans involved had originally been established.[8/] The interpretation described the abuses and found them contrary to the public interest. It stated that to the extent member dealers, sponsors, and underwriters participated in this activity, their conduct would be deemed inconsistent with "high standards of commercial honor and just and equitable principles of trade," within the meaning of Article III, Section 1, of its Rules of Fair Practice.

In elaboration, the NASD declared that practices detrimental to the interests of shareholders of the investment company issuing the securities underlying the contractual plan included, but were not limited to, the following:

"1. The suggestion, encouragement, or assistance to (or any arrangement which encourages or assists) a planholder in:

a) making repeated or excessive use of the withdrawal and reinstatement privilege (ordinarily, use of the privilege by a planholder more frequently than once during the period of a year will be viewed as excessive);

b) reinstating the investment within 90 days after withdrawing shares or cash;

c) making use of the withdrawal privilege within six months after the most recent investment in the plan, other than the reinvestment of a dividend or distribution. (This is not intended to interfere with the right of a planholder to liquidate all or a portion of his plan account or to withdraw his shares at any time, but is intended to restrict the use of the reinstatement privilege as to shares or cash which has been withdrawn during the six-month period);

8/ This interpretation appears in CCH NASD Manual ¶5261 (1967).

d) using the privilege to provide funds for temporary investment in other securities;

e) using the privilege for the purpose of taking advantage of fluctuations in the net asset value per share of the investment company.

"2. Any arrangement, or the use of any arrangement, whereby a custodian bank or other person performing a similar function will accept telephone, teletype, or telegraphic requests or instructions for the withdrawal of shares or cash from a plan account, whether such requests or instructions are received from a member or from a planholder.

"3. Any arrangement, or the use of any arrangement, whereby a custodian bank or other person performing a similar function will accept telephone, teletype, or telegraphic requests or instructions, or condition orders, to reinstate shares previously withdrawn from a plan account, whether such requests or instructions are received from a member or a planholder.

"4. Any arrangement, or the use of any arrangement, whereby a custodian bank will withdraw shares or cash from a plan account, or reinstate shares previously withdrawn, upon a power of attorney, executed by a planholder appointing a member or an associated person of a member, as the attorney of the planholder." CCH NASD Manual ¶5261 (1967).

Subsequent discussion between the Fund sponsor and NASD representatives resulted in a letter to the sponsor from the NASD, dated October 13, 1966, stating that certain revised procedures for the administration of the withdrawal-and-reinstatement privilege proposed by the Fund sponsor, although not as stringent as those established by the NASD Interpretation, would be deemed to constitute substantial compliance with the Interpretation, assuming that "natural attrition" shrinks the remaining speculative activity rapidly. (Ratzlaff Deposition, Plaintiffs' Exhibit 8, p. 7 and Plaintiffs' Exhibit 9, pp. 1-2.) These adjusted procedures, however, did not effect

the anticipated attrition--thereby causing the NASD to advise the Fund sponsor on August 28, 1967, and the Fund sponsor in turn to advise its programholders and the custodian bank on September 8, 1967, that henceforth the Fund sponsor would be required to comply strictly with the NASD Interpretation or it could be subject to disciplinary action (Ratzlaff Deposition, Plaintiffs' Exhibit 10, pp. 1-2.)

THE STATUTORY PATTERN

Section 15A of the Securities Exchange Act, added by the Maloney Act in 1938, provides for cooperative regulation of the over-the-counter securities industry[9/] through the registration with the Commission of one or more "national Securities associations."[10/] The philosophy underlying the Maloney Act has been aptly described in these terms:

> "While the provisions [of the Exchange Act] on registration, inspection, and prevention and punishment of fraudulent practices furnish an indispensable foundation for an adequate system of control [by the Commission], they must be supplemented by regulation on an ethical plane in order

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9/ A description of the over-the-counter securities markets was given in the REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, Pt. 2, 88th Cong., 1st Sess. 541 (1963):

> "Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. . . . [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience, and function; the securities differ in price, quality, and activity."

10/ Loss, Securities Regulation 1361 (2d ed. 1961).

'to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry' and 'to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market.' */ And regulation of the ethics of an industry means a substantial degree of self-regulation, properly supervised by government.

"*/ S. Rep. No. 1455 at 3 and H.R. Rep. No. 2307 at 4, 75th Cong., 3d Sess. (1938)."

The NASD, organized as a Delaware non-profit corporation, was formed to supervise the business conduct of over-the-counter broker-dealers and, as we have noted (supra, p. 2), is the only association which has been so registered. 11/

Before an association may be registered, it must satisfy the Commission that it has met a number of standards. For example, subject to specified exceptions, membership generally must be open to any over-

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11/ While broker-dealers who are themselves registered with the Commission may do an over-the-counter securities business without joining the NASD, Section 15A(i)(1) authorizes a registered securities association to "provide that no member thereof shall deal with any non-member broker or dealer . . . except at the same price, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." Thus, by reason of NASD rules adopted pursuant to this authorization, "it is virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of important size." National Association of Securities Dealers, Inc., 19 S.E.C. 424, 441 (1945). See also Berko v. Securities and Exchange Commission, 316 F. 2d 137 (C.A. 2, 1963). Since "[v]irtually all mutual fund underwriters which distribute shares through independent broker-dealers are NASD members themselves . . . such broker-dealers must, as a practical matter, belong to the NASD." REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 62 (1966).

the-counter broker or dealer who applies.[12] It must have rules designed, inter alia,

> ". . . to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to fix minimum rates of commissions, allowances, discounts, or other charges." [13]

After registration is effected, in order to assure consistency with the statutory requirements, the Maloney Act confers upon the Commission broad powers of review with respect to both new rules and amendments to existing rules promulgated by the association. The Act (1) requires all new rules or amendments to lie on the Commission's table subject to veto for thirty days before they become effective, during which period the Commission must determine whether they meet the statutory standards, including those quoted above;[14] and (2) subjects all rules of association to abrogation by the Commission under appropriate circumstances at any time. Subsections (j) and (k) of Section 15A, 15 U.S.C. 78o-3(j) and (k).

12/ Subsection (3) and (4) of Section 15A(b), 15 U.S.C. 78o-3(b)(3) and (4).

13/ Section 15A(b)(8), 15 U.S.C. 78o-3(b)(8).

14/ See National Association of Securities Dealers, Inc., 12 S.E.C. 322 (1942) (proposed minimum capital rule disapproved).

The Act also requires that an association's rules are to "provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules," and "provide a fair and orderly procedure with respect to the disciplining of members . . . ."[15/] In this regard, a report to Congress by the Commission in 1963 stated:[16/]

> "The NASD is a creature of statute and it is primarily engaged in regulatory activities. Unlike the exchanges it did not exist as an organization prior to the adoption of the Exchange Act; the NASD was specifically established to govern conduct in the over-the-counter markets. . . . and, of primary importance, it must discipline those who violate its rules."

Subsections (g) and (h) of Section 15A, 15 U.S.C. 78o-3(g) and (h), subject any disciplinary action by an association to Commission review, either on application by any person aggrieved or on the Commission's own motion, with provision for an automatic stay pending review.[17/]

15/ Sections 15A(b)(9) and (10), 15 U.S.C. 78o-3(b)(9) and (10). The delegation of disciplinary power to the NASD has been judicially upheld. R. H. Johnson Co. v. Securities and Exchange Commission, 198 F. 2d 690 (C.A. 2), certiorari denied, 344 U.S. 855 (1952).

16/ REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, Pt. 4, 88th Cong., 1st Sess., 603-605 (1963).

17/ Section 15A(h)(1) provides that the Commission's review shall be "upon consideration of the record before the association and such other evidence as it may deem relevant." That section requires the Commission to set aside an association's action if it finds that the evidence does not warrant the association's finding of violation of its rules or that the rules were improperly applied, and to cancel or reduce the penalty if it finds it to be "excessive or oppressive."

The Commission's decision is subject to judicial review in a court of appeals under Section 25 of the statute, 15 U.S.C. 78y.

The Commission's authority over a registered securities association also includes power to discipline the association and its officials,[18] and to impose recordkeeping requirements upon the association and make reasonable periodic, special or other examinations of the records so required.[19] While the Commission has never felt it necessary to utilize these powers, because it has achieved comparable supervision through close day-to-day contact and cooperative efforts by Commission and NASD representatives, the statutory provisions authorizing this type of supervision illustrate the breadth of the oversight by the Commission intended by Congress.

18/ Section 15A(1), 15 U.S.C. 78o-3(1).

19/ Section 17(a), 15 U.S.C. 78q.

ARGUMENT

I. CONTRACTS ENTERED INTO WITH OTHERS BY MEMBERS OF A REGISTERED SECURITIES ASSOCIATION MUST BE DEEMED TO BE SUBJECT TO THE RULES OF SUCH ASSOCIATION IF EFFECTIVE SELF-REGULATION OF BROKER-DEALERS CONTEMPLATED BY THE MALONEY ACT IS TO BE ACHIEVED.

The NASD, as a registered national securities association, exercises major self-regulatory responsibilities in the administration and enforcement of certain aspects of the federal securities laws expressly delegated to it by Congress. This regulatory power was considered to be a preferable "alternative [to the] pronounced expansion of the organization of the Securities and Exchange Commission." S. Rep. No. 1455 at 3-4 and H.R. Rep. No. 2307 at 4-5. Hence, since the NASD, subject to supervision of the Commission, is authorized to function as a quasi-governmental agency, the effect of its rules and orders on contracts entered into by its members should be comparable to those of a governmental regulatory agency, at least as to those rules the NASD is required by law to have in order to be a registered national securities association. As we have seen, the NASD's rule of fair practice here involved was designed to meet the requirement that the association must have rules "designed . . . to promote just and equitable principles of trade . . ." (p. 9, supra). Because the defendant Growth Programs is a member of the NASD, its contract with the plaintiffs must be assumed to have been

entered into subject to this rule of fair practice,[20/] since all enforceable contracts are, of course, entered into subject to provisions of the governing law.

The NASD's interpretation of its rule requires adherence by NASD members to high standards of commercial honor and just and equitable principles of trade. As we have seen, the speculative use of the withdrawal-and-reinstatement privilege operates to the detriment of fund shareholders generally and is not consistent with the purpose of this privilege, which was to permit a plan shareholder faced with an emergency to withdraw a portion of his investment and later replace it without incurring an additional sales charge. Under the circumstances, the NASD's determination that the privilege must be exercised only in a manner that would serve its original purpose is wholly consistent with its responsibilities of regulating the activities of its members. Certainly the fact that the defendants had permitted the plaintiffs to use the privilege as a speculative vehicle cannot affect the validity of the NASD's interpretation that it is improper for it to be so used.

That rules of a self-regulatory organization under the supervision of the Commission sometimes have the force of law was recently

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20/ Section 4 of Article I of the by-laws of the NASD provides that in order to become a member of the NASD, an applicant must agree to abide by, comply with, and adhere to, inter alia, all the rules and regulations of the NASD, and all rulings, orders, directions and decisions of, and penalties imposed by, the Board of Governors or any duly authorized NASD committee. CCH NASD Manual §1104 (1967).

illustrated in Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., CCH Fed. Sec. L. Rep. ¶ 92,378 (C.A. 7, April 17, 1969), which held that a complaint based on a violation of a rule of the New York Stock Exchange may be actionable. The court there determined that it had jurisdiction under Section 27 of the Securities Exchange Act, giving district courts "jurisdiction of violations of . . . [the Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by . . . [the Act] or the rules and regulations thereunder." It held that a violation of Rule 405 of the New York Stock Exchange "may be actionable as a 'duty created by this Chapter' inasmuch as Rule 405 was promulgated in accordance with . . . provisions of the Act." It stated: "The touchstone for determining whether or not the violation of a particular rule [of the Stock Exchange] is actionable should properly depend upon its design 'for the direct protection of investors.'" Cf. Colonial Realty Association v. Bache, 358 F. 2d 178, 180-183 (C.A. 2, 1966).

Here, too, there is involved a rule of a self-regulatory agency under the jurisdiction of the Commission adopted "for the direct protection of investors." If implied liability might be predicated upon the violation of an NASD rule with this purpose, certainly such a rule would seem to have sufficient status to make unenforceable any contracts to which its members are parties that conflict with the proper interpretation of the rule.

The interpretation here challenged was appropriately issued by the NASD's Board of Governors, as contemplated by the NASD's by-laws, and received the active and affirmative concurrence of this Commission (see p. 9, supra).[21/] Specific applications of interpretations by the NASD's Board of Governors of its Rules of Fair Practice have previously received approval by both the Commission and the courts.[22/] For example, the validity of the NASD's mark-up policy, which is also in part an interpretation of its rule on just and equitable principles of trade, was first sustained

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21/ Unlike the adoption of a new rule, this interpretation of an existing rule was not required first to be filed formally with the Commission prior to its promulgation. It was, however, submitted in advance to the Commission for review and comment, as we have seen (p. 9, supra). Moreover, it was filed with the Commission pursuant to the requirements of Section 15A(j) of the Act and Commission Rule 15Aj-1 under the Act, 17 CFR 419, as a supplement to the NASD's registration statement. The latter provisions call for the filing of such supplement where rules or "settled practices" of the association having the effect of a rule are amended or supplemented. See Form X-15AA-1 of the Commission and Instruction 5 of that form, 17 CFR 507.

22/ In addition to the Interpretation with Respect to Contractual Plan Withdrawal and Reinvestment Privileges, which appears in CCH NASD Manual (1967) at page 5061, matters dealt with by the NASD by means of interpretation have covered a broad range of subject areas and may be found in CCH NASD Manual (1967) at the following pages: Advertising, 2015; "Free-Riding and Withholding," 2018; Review of Underwriting Arrangements, 2021; Execution of Retail Transactions in the Over-the-Counter Market, 2024; NASD Markup Policy, 2054; Manipulative and Deceptive Quotations, 2071; Transactions Between Members and Non-Members, 2099; Transactions Effected for Personnel of Other Members, 2110; The Effect of a Suspension or Revocation of the Registration, If Any, of a Person Associated with a Member or the Barring of a Person from Further Association with a Member, 2114; Rates of Return, 5022; Sales Literature Featuring Income, 5023; Custodial Service, 5025; Comparisons, 5026; Sales Commissions, 5031; "Special Deals," 5092; Dealers Compensation of Salesmen for Sales of Investment Company Shares, 5094; Selling Dividends, 5264; Prompt Payment by Members for Shares of Investment Companies, 5097; Breakpoint Sales, 5097; Arranging Loans, 5267.

by the Commission in 1944. See National Association of Securities Dealers, Inc., 17 S.E.C. 459. The validity of that interpretation has also been upheld by the courts. Handley Investment Company v. Securities and Exchange Commission, 354 F. 2d 64 (C.A. 10, 1965); Samuel B. Franklin & Co. v. Securities and Exchange Commission, 290 F. 2d 719 (C.A. 9), certiorari denied, 368 U.S. 889 (1961). In that connection, the Court of Appeals for the Tenth Circuit in the Handley case overruled a contention that "the NASD rules failed to satisfy due process requirements for definite standards and that the application of the rules to the petitioner deprived him of the right to engage in the securities business" (354 F. 2d at 66), concluding:

> "Absent constitutional or statutory infirmities, none of which appear here, the professional standards established by NASD and SEC for those engaging in over-the-counter securities business will not be upset by the courts."

The interpretation with respect to the withdrawal-and-reinstatement privilege was issued only recently because, as we have noted, it was not until the last few years that situations arose presenting the problem. Until then this privilege was apparently utilized only, as intended, to provide a means whereby a plan shareholder would be able to cash in his shares when necessary without incurring an additional sales charge upon his reinvestment. Because excessive use of this privilege necessarily will place a burden on a mutual fund to maintain a highly liquid position and dilute the interests of shareholders in the fund, it would hardly be expected that the Board of Governors of the NASD would not construe this

practice as contrary to fair and equitable principles of trade within the meaning of its Rules of Fair Practice.

Even if it should be assumed, however, that the interpretation by the NASD, instead of being an expression of what its rule has long encompassed, represents a change in its views as to what the basic standards mean or to what situations they should be applied, that change should have no lesser effect on the members' contracts than would a change in the governing law or in a Commission or court interpretation of that law. See, e.g., Norman v. Baltimore & Ohio Railroad Co., 294 U.S. 240, 305 (1935), which states that "contracts must be understood as having been made in reference to the possible exercise of the rightful authority of the Government, and that no obligation of a contract 'can extend to the defeat' of that authority."

That an action by a quasi-governmental body within the self-regulatory scheme of the Securities Exchange Act, such as the NASD, may legitimately have a regulatory effect upon a non-member, as well as upon one of its members, was recognized by the Supreme Court in Silver v. New York Stock Exchange, 373 U.S. 341 (1963). The Court there observed that duties imposed by the Securities Exchange Act upon the stock exchanges with respect to the adoption and enforcement of their rules involve both exchange members and non-members, and often weigh more heavily against the latter than against the former. It then stated:

> "One aspect of the statutorily imposed duty of self-regulation is the obligation to formulate rules governing the conduct of exchange members. The Act specifically requires that registration cannot be granted '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 . . .,' §6(b), 15 U.S.C. §78f(b). In addition, the general requirement of §6(d) that an exchange's rules be 'just and adequate to insure fair dealing and to protect investors' has obvious relevance to the area of rules regulating the conduct of an exchange's members.

"The §6(b) and §6(d) duties taken together have the broadest implications in relation to the present problem, for members inevitably trade on the over-the-counter market in addition to dealing in listed securities, and such trading inexorably brings contact and dealings with non-member firms which deal in or specialize in over-the-counter securities. It is no accident that the Exchange's Constitution and rules are permeated with instances of regulation of members' relationships with nonmembers including non-member broker-dealers." (Emphasis supplied.) 373 U.S. at 353-354.

* * *

"Rules which regulate Exchange members' doing of business with nonmembers in the over-the-counter market are therefore very much pertinent to the aims of self-regulation under the 1934 Act." 373 U.S. at 355.

* * *

"The Exchange's enforcement of such rules inevitably affects the nonmember involved, often (as here) far more seriously than it affects the members in question. The sweeping of the nonmembers into the currents of the Exchange's process of self-regulation is therefore unavoidable." (Emphasis supplied.) 373 U.S. at 356.

Subsections (b) and (d) of Section 6 of the Exchange Act, cited in Silver, dealing with stock exchanges, have provisions for rules governing membership comparable to those in Sections 15A(b)(8) and 15A(b)(9) of the Maloney Act here involved, dealing with registered associations of securities dealers. Indeed, Section 6(b) includes a requirement for rules to promote "just and equitable principles of trade"--the identical language contained in Section 15A(b)(8), pursuant to which the rule here involved was adopted. As recognized in Silver with respect to the stock exchange and its members, the duties imposed by the NASD "have the broadest implications in relation" to the case at bar because members of the NASD inevitably trade with customers, such as those plaintiffs who are non-members of the NASD. Furthermore, as is true with respect to stock exchanges, it is "no accident that the [NASD's rules and interpretations are also] permeated with instances of regulation of members' relationships with nonmembers." It may also be said that the rules of the NASD that regulate NASD "members' doing business with non-members are therefore very much pertinent to the aims of self-regulation under the 1934 Act"; and as evidenced by the instant case, the NASD's "enforcement of such rules may inevitably affect the non-member involved. . . ." Hence, the conclusion seems logically to follow that "the sweeping of the non-members into the currents of the [NASD's] process of self-regulation is therefore unavoidable."

The facts presented in the case at bar suggest, moreover, that planholders had constructive, if not actual, knowledge of the sponsor's obligation to comply with all existing and prospective standards of conduct established by the NASD for adherence by its members. All purchasers of the contractual plans in question were given notice that Growth Programs, Inc., the sponsor, was a member of the NASD by an express statement on page nine of the prospectus:

> "The sponsor is a Delaware corporation organized in November, 1961. It is a registered broker/dealer under the Securities Exchange Act of 1934 and a member of the National Association of Securities Dealers, Inc. and is primarily engaged in the distribution of Programs through broker/dealer members of the Association." (Chorn, Plaintiffs' Exhibit 78-A.)

The obligation on the part of Growth Programs to conform to NASD's requirements would thus appear to be a clearly implied condition pursuant to which the single-payment contractual plans involved herein were purchased.

Accordingly, we submit that it would be wholly contrary to the regulatory aims of the Act for this Court to hold that the NASD's interpretation of its rule is not applicable to the contracts here involved. If, as here, a member of the NASD enters into a relationship with a non-member, which relationship is contrary to "just and equitable principles of trade" because of its unfairness to numerous other investors, the non-members should not be permitted to prevent the NASD from terminating that relationship; otherwise the NASD will be

unable to perform the important functions intended by Congress for such an association. If the Court should find that Growth Programs has overreached the plaintiffs in inducing the contract, damages, rescission or other appropriate relief might be granted.[23/]

II. COLLECTIVE ACTION UNDER COMMISSION SUPERVISION BY THE NASD AND ITS MEMBERS IN PROMULGATING NEW RULES OR NEW INTERPRETATIONS OF EXISTING RULES AND IN ENFORCING THOSE RULINGS IS CLEARLY CONTEMPLATED UNDER THE SECURITIES EXCHANGE ACT AND CANNOT WITHOUT MORE CONSTITUTE A VIOLATION OF THE ANTITRUST LAWS.

The express provisions of the Securities Exchange Act, supra, pp. 12-16, clearly contemplate collective action by "national securities associations" and their members in promulgating and enforcing rules. As noted in its legislative history, the Maloney Act

> "is based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation." S. Rep. No. 1455 at 4 and H.R. Rep. No. 2307 at 4, 75th Cong., 3d Sess. (1938).

23/ This is not to suggest, however, that the adoption by the NASD of a new rule of fair practice or its interpretation of an existing rule should, without more, result in liability in damages by NASD members who, as a consequence of such rule or interpretation, must cease certain activity which may have been profitable to some of their customers. Such a result would undercut the efficacy of the statutory concept of a self-regulating body undertaking to enforce compliance with ethical, as well as legal, standards in a changing industry.

As a safeguard to the exercise of this collective power, antitrust concepts are embodied in the Maloney Act through provisions in Section 15A(b)(8). These require, inter alia, that a registered association's rules be "not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." In addition, the association's rules are required under that subsection "to remove impediments to and perfect the mechanism of a free and open market." These provisions must be enforced by the Commission not only in connection with its findings when an association seeks to register but also through the Commission's power to abrogate rules when necessary to "effectuate the purposes" of the Securities Exchange Act (Section 15A(k)(1)) and in its review of the association's disciplinary proceedings (Section 15A(h)(1)).

If the NASD's adoption of rules and regulations, or interpretations thereof, in conformity with the Maloney Act, could be held to constitute a conspiracy of its members in violation of the antitrust laws, the entire regulatory pattern contemplated by the Maloney Act would be rendered ineffective. Self-regulation necessarily requires collective action, which restrains those subject to it in their dealings with third parties, as well as with each other. If such collective restraint is a violation of the antitrust laws, the statutory scheme of self-regulation becomes inoperable.

Although the Act contains no explicit antitrust immunity for actions taken by a "national securities association," subsection (n) of Section 15A, 15 U.S.C. 78o-3(n), provides

> "If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail."

This provision has been interpreted by the Supreme Court as conferring upon any such association a measure of antitrust immunity.[24/] United States v. Socony Vacuum Oil Co., 310 U.S. 150, 227 (1940), pointed to

> ". . . the Maloney Act (§15A of the Securities Exchange Act of 1934; 52 Stat. 1070) providing for the formation of associations of brokers and dealers with the approval of the Securities and Exchange Commission and establishing continuous supervision by the Commission over specified activities of such association" [25/]

as an illustration of a method adopted by Congress for "securing immunity" from the penalties of the Sherman Act "through the scrutiny and approval of designated public representatives."

24/ In the absence of immunity, the securities business, like every other form of interstate trade and commerce, is of course subject to the Sherman Act, 15 U.S.C. 1, et seq. United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944); United States v. National Association of Real Estate Boards, 339 U.S. 485 (1950); cf. United States v. Morgan, 118 F. Supp. 621 (S.D. N.Y., 1953).

25/ See also International Association of Machinists v. Street, 367 U.S. 740, n.16 (1961) (dissenting opinion of Mr. Justice Frankfurter), indicating that "Sections 15A(i) and (n) of the Exchange Act authorize the NASD to formulate rules which stipulate that members shall refuse to deal with nonmembers with immunity from the antitrust laws."

Indeed, even without a provision comparable to subsection (n) of Section 15A, it has been made clear that the self-regulation contemplated by the registered stock exchanges in adopting regulations to govern their members does not normally violate the antitrust laws. Silver v. New York Stock Exchange, supra, 373 U.S. 341 (1963); Kaplan v. Lehman Brothers, 371 F. 2d 409 (C.A. 7), certiorari denied, 389 U.S. 954 (1967), rehearing denied, 390 U.S. 912 (1968).

Kaplan v. Lehman Brothers, supra, held that the fixing of minimum commission rates by a stock exchange does not constitute a violation of the Sherman Act since the promulgation of rules respecting such rates was contemplated by the Securities Exchange Act, subject to the regulation and supervision of the Commission. The court of appeals therein noted with approval (371 F. 2d at 411) the statement by the Supreme Court in the Silver case that "although the 'Securities Exchange Act contains no express exemption from the antitrust laws,' a 'repeal' thereof is to be regarded as implied 'if necessary to make the Securities Exchange Act work.'"[26/]

26/ Cf. Baum v. Investors Diversified Services, Inc., CCH Fed. Sec. L. Rep. ¶ 92,220 (N.D. Ill., May 20, 1968), which holds that an investment company practice approved by the Commission pursuant to its regulatory powers under the Investment Company Act cannot be attacked as illegal per se under the antitrust laws. In ruling that the system of cumulative quantity discounts in the sale of mutual funds is immune from attack under the Robinson-Patman Act, the district court stated that

> ". . . a challenge based upon the argument that the system [of quantity discounts] is a per se violation of the Robinson-Patman Act, cannot succeed, since the system exists pursuant to a statutorily authorized rule of the SEC." Id. at p. 97,022.

The Silver case made clear that there could be no per se violation of the antitrust laws merely because of a concerted refusal by the exchange's members to deal with a non-member, so long as this was pursuant to a regulation within the scope of the "statutorily imposed duty of self-regulation," 373 U.S. at 353. It held, however, that, since there was no check by the Commission on the New York Stock Exchange's application of its rules as to the use of private wire connections by members and non-members, court review was appropriate under the antitrust laws. It determined in that case that arbitrary procedures followed by the Exchange in refusing to advise a non-member why it had insisted on cancellation of its direct telephone wires to members had been neither authorized nor contemplated by the Securities Exchange Act. Accordingly, it held that there was no absolute antitrust immunity, but that it could subsequently be determined in an antitrust suit whether the "particular enforcement" of the rules challenged should be governed "by a standard of arbitrariness, good faith, reasonableness, or some other measure." 373 U.S. at 366.

We have seen that, unlike in Silver, the reasons for the action taken by the NASD here involved were fully spelled out by the NASD and were fully consistent with the purposes of the Securities Exchange Act because of the abuse of the withdrawal-and-reinstatement privilege that had arisen. Therefore, whether or not, in the light of subsection (n) of Section 15A, the holding in Silver would be equally applicable to the NASD had that association acted unreasonably is not involved in this case.

III. THE COMPLAINT AGAINST THE NASD SHOULD BE DISMISSED FOR FAILURE TO STATE A CLAIM UPON WHICH RELIEF CAN BE GRANTED SINCE, SHOULD THE COURT GRANT THE RELIEF DEMANDED, IT WOULD UNDERCUT THE EFFICACY OF COOPERATIVE REGULATION AS CONTEMPLATED BY THE MALONEY ACT.

We have pointed out the numerous ways in which a national securities association is subjected to the supervision of the Commission. Of particular applicability here is subsection (k) of Section 15A of the Exchange Act, 15 U.S.C. 78o-3(k), which places upon the Commission the obligation to maintain constant surveillance over the rules of any registered "national securities association" in order to insure that such rules conform to the policy of the statute. In addition to its duty of passing on an association's rules to determine whether they conform to the purposes of the statute when an association registers, and when new rules are adopted or rules are amended, as we have seen, the Commission may abrogate an association's rules when found to be "necessary or appropriate to assure fair dealing by the members of such association . . . or otherwise to protect investors or effectuate . . ." the purpose of the Act.[27/] This necessarily includes power to abrogate a rule in whole or in part insofar as the rule or its interpretation may be found by the Commission to be contrary to statutory policy. Should a rule or its interpretation not conform to the statutory purposes, including those discussed at pp. 13-15, 27-28, supra, of an antitrust character, it would be the Commission's duty to take appropriate corrective steps. Accordingly, a court determination in an action such as this that the NASD's rule, as interpreted by its Board of Governors, is unlawful under the Sherman Act or that for some other reason it should not be applied

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27/ Section 15A(k)(1), 15 U.S.C. 78o-3(k)(1).

to existing contracts would impair the regulatory functions of the Commission contemplated by the Maloney Act.

Federal regulation of the securities markets is unique in that certain nongovernmental institutions are required to police the industry subject to continuing governmental oversight. Self-regulation, in this regard, involves administratively supervised,collective action by association members not only in the adoption of self-regulatory rules and rule interpretations but also in their enforcement by sanctions suitable to guarantee compliance--consisting, in the words of the Supreme Court in Silver, of "a type of partnership between government and private enterprise." 373 U.S. at 366. Thus, consonant with the "federally mandated duty of self-policing" that the Supreme Court in Silver stated had been created by the Securities Exchange Act (373 U.S. at 352), an enforcement duty was specifically placed upon the NASD by certain provisions of the Maloney Act Amendments to the Securities Exchange Act. See., e.g., Sections 15A(b)(4) and (9) of the Act, 15 U.S.C. 78o-3(b)(4) and (9). While disagreeing with the disposition of the Silver case in other respects, Mr. Justice Stewart aptly described this concept:

> "The purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry." 373 U.S. at 371.

The NASD through the collective action of its members cannot be expected to be vigorous in adopting and enforcing rules and interpretations governing the conduct of their business if they are subject to the threat of damages

while acting within the area of their statutory responsibility and with the affirmative concurrence of this Commission.

CONCLUSION

For the foregoing reasons, the pending motions of the plaintiffs should be denied, the motion of the NASD should be granted and the motions of the other defendants should also be granted insofar as their activities complained of are based on their compliance with the interpretation of the NASD.

Respectfully submitted,

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June 27, 1969