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NLRB v. Wyman-Gordon Co.: Subsequent Retroactive Application of Prospectively Promulgated Decisional Rule Approved by High Court

As part of an order to conduct a representation election, the National Labor Relations Board directed Wyman-Gordon Co. to deliver to the district director a list of the names and addresses of all eligible voters for the use of the union in the election campaign. Wyman-Gordon refused. A subpoena duces tecum was issued by the Board, which was likewise refused. The Board petitioned federal district court for enforcement of the subpoena, which was granted[1] on the ground that the list sought was required by the Board's prior action in *Excelsior Underwear, Inc.*[2] The court of appeals reversed,[3] holding the *Excelsior* rule invalid because made in violation of the rule-making procedures set out in the Administrative Procedure Act.[4] The United States Supreme Court granted certiorari.[5] *Held, reversed*: Although the *Excelsior* rule was promulgated without compliance with the rule-making procedures of the APA, the directive to produce the list of names and addresses in *this* case was a valid part of a final order in a representation election adjudication and must be enforced. *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759 (1969).

I. Administrative Procedure Act

The NLRB has often been criticized for its failure to make use of the rule-making procedures set out in the APA.[6] It has traditionally held itself out to be primarily a quasi-judicial body, stating that adjudicatory procedures are more compatible with its functions.[7] This is not to say that the Board is unfamiliar with the *ideas* behind the rule-making procedural requirements of the APA.[8] In adjudicatory proceedings a limited number of outside parties are often invited to submit amicus briefs. Comments on a given area are sometimes invited when no case is pending, and decisions and policy statements are at times circulated throughout the industry via press release.[9]

But the APA requires more. Section 4[10] (rule-making) provides for notice of proposed rule-making in the *Federal Register*, an opportunity for

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[1] NLRB v. Wyman-Gordon Co., 270 F. Supp. 280 (D. Mass. 1967).

[2] 156 N.L.R.B. 1236 (1966).

[3] Wyman-Gordon Co. v. NLRB, 397 F.2d 394 (1st Cir. 1968).

[4] 5 U.S.C. §§ 1001-11 (1964) [hereinafter referred to as the APA].

[5] 393 U.S. 932 (1968).

[6] *See* 1 K. Davis, Administrative Law § 6.13 (Supp. 1967); Peck, *The Atrophied Rule-Making Powers of the National Labor Relations Board*, 70 Yale L.J. 729 (1961); Chairman's Page, 16 Ad. L. Rev. 77 (1963).

[7] Peck, *supra* note 6, at 730 nn.7-9, and related text.

[8] These ideas could be summarized as (1) general notice as to substance and subject of proposed rule-making, (2) opportunity for interested persons to participate through submission of views, data, or arguments, and (3) adequate notice of a substantive rule before its effective date. *See* note 10 *infra*, and accompanying text.

[9] *See, e.g.*, Peck, *supra* note 6, at 735-36; NLRB Press Release R-449, Revision of NLRB Jurisdictional Standards, 34 L.R.R.M. 75 (1954).

[10] 5 U.S.C. § 1003 (1964).

submission of briefs or arguments by interested parties, and publication of the resulting rule in the *Federal Register* at least thirty days before its effective date. "Rule" is defined as "an agency statement of general . . . applicability and future effect designed to implement, interpret or prescribe law or policy . . . ."[11] Section 5[12] (adjudication) provides for a hearing for the parties and for notice to them of "the matters of fact and law asserted."[13] It specifically exempts proceedings for "the certification of employee representatives"[14] from the normal adjudicatory procedure. "Order" is defined as "a final disposition of an agency matter other than rule-making."[15] Courts are authorized by section 10(e)[16] to set aside agency action which is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law [or] without observance of procedure required by law . . . ."[17]

The problem most encountered by the Board in seeking enforcement of, or in defending appeals from, its decisions has been the charge of "arbitrary and capricious." This often arises from the Board's retroactively applying a new "rule" to the parties before it. Several such "decisional rules" have been overturned by the courts of appeals on this ground.[18]

II. THE EXCELSIOR RULE

A consent election was conducted among the employees of Excelsior Underwear Co. in which the union was defeated. The union filed objections to the election based, in relevant part, on Excelsior's refusal during the campaign to honor the union's request for a list of names and addresses of employees for the purpose of answering a letter sent to these employees by the company. The regional director recommended that the union's objections be overruled and that the election results be certified. The union filed objections to this recommendation. The Board decided that this question was of "substantial importance" and ordered oral argument, inviting certain other parties to file amicus briefs.[19] The attention of all

[11] *Id.* § 1001(c).
[12] *Id.* § 1004.
[13] *Id.* § 1004(a)(3).
[14] *Id.* § 1004(6).
[15] *Id.* § 1001(d).
[16] *Id.* § 1009(e).
[17] *Id.*
[18] *See, e.g.*, NLRB v. E. & B. Brewing Co., 276 F.2d 594 (6th Cir. 1960). There the Board declared the "hiring hall" clause before it—and all other "hiring hall" clauses—illegal unless accompanied by three specific limiting provisions. The court of appeals reversed: "We hold that the Board cannot establish its attempted rule by an adjudication of a matter not in issue before it." *Id.* at 599. Recognizing that an adjudicatory policy change may be retroactive in an appropriate case, the court stated the test to be whether "the practical operation of the Board's change of policy . . . [will] work hardship upon respondent altogether out of proportion to the public ends to be accomplished." *Id.* at 600, citing NLRB v. Guy F. Atkinson Co., 195 F.2d 149 (9th Cir. 1952). The court felt the Board could have reached the desired end by a valid exercise of its rule-making power. *Cf.* Local 375, Int'l Bhd. of Teamsters v. NLRB, 365 U.S. 667 (1961).
[19] The invitation was accepted by: the Chamber of Commerce of the United States; AFL-CIO; International Union of Electrical, Radio and Machine Workers, AFL-CIO; International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, UAW-AFL-CIO; the National Association of Manufacturers; Retail Clerks International Association, AFL-CIO; and Textile Workers Union of America, AFL-CIO.

parties was directed to the question: "Can a fair and free election be held when the union involved lacks the names and addresses of employees . . . and the employer refuses to accede to the union's request therefor?"[20] The Board ultimately ordered that, in all elections ordered or consented to after thirty days from the date of its decision, the company would give to the regional director a list of the names and addresses of the eligible voters. Recognizing this to be a basic change in the election procedure,[21] the Board did not make this order applicable to the parties before it and gave all others time to prepare for the new procedure. The original Excelsior Underwear Co. election was certified.[22]

The parties were notified that the change was to be considered and other parties were invited to submit amicus briefs. But the issue for consideration, as stated by the Board, indicates that the Board was concerned not with the fairness of the election activities of Excelsior Underwear Co., but with a broad question of general policy. Resolution of such questions calls for rule-making proceedings.[23] All interested parties, not just a select few, must be advised of the issues by notice in the *Federal Register* and given the opportunity to submit their views in writing. The results of such proceedings must be published in the *Federal Register* at least thirty days before their effective date. While the "rule" announced in *Excelsior* did not become effective for thirty days, no notice of the proceeding—prior or subsequent—was published in the *Federal Register*.[24]

Subsequent Board orders based on the *Excelsior* rule have been approved by the circuit courts of appeals which reviewed them. The Fourth[25] and Seventh[26] Circuits did so, citing the Board's broad power over election proceedings[27] and the "substantive soundness" of *Excelsior*, without discuss-

[20] Excelsior Underwear, Inc., 156 N.L.R.B. 1236, 1238 (1966).

[21] Previously, companies were required to produce a list of names at election time to be used in conducting the election day proceedings and in making challenges to voter eligibility. *Id.* at 1239.

[22] It is noteworthy that over two years elapsed between the election and certification of it by the Board. It cannot be seriously contended that *Excelsior* would not have been disposed of in far less time had the Board been concerned only with the fairness of that particular election. Nor can it seriously be contended that a speedier resolution of the controversy would not have produced greater justice to the parties. But such is the price of having your case selected as the vehicle for announcing a general rule.

[23] *See* notes 10, 11 *supra*, and accompanying text.

[24] "[W]e consider that the Board, to put it bluntly, designed its own rule-making procedure, adopting such part of the Congressional mandate as it chose, and rejecting the rest." Wyman-Gordon Co. v. NLRB, 397 F.2d 394, 396-97 (1st Cir. 1968).

[25] NLRB v. Hanes Hosiery Div., 384 F.2d 188 (4th Cir. 1967).

[26] NLRB v. Rohlen, 385 F.2d 52 (7th Cir. 1967).

[27] Those courts noting the Board's broad power over representation election proceedings cited only NLRB v. Waterman S.S. Corp., 309 U.S. 206 (1940), in support. In *Waterman* the Supreme Court stated: "The control of the election proceedings, and the determination of the steps necessary to conduct that election fairly were matters which Congress left to the Board alone." *Id.* at 226. AFL v. NLRB, 308 U.S. 401 (1940), and NLRB v. Falk Corp., 308 U.S. 453 (1940), were cited in support of this statement. In those two cases, the Court construed § 9(d) of the Wagner Act, 29 U.S.C. § 159(d) (1964), to mean that an NLRB certification order could not be appealed directly to the courts, but could be considered only as part of an unfair labor practice hearing. For example: the Board orders a company to negotiate with a certified representative, the company refuses, and the Board seeks enforcement of its order in a court of appeals. At that time the entire record—including the certification order—is reviewable.

Granting that Wagner Act § 9(d) and the Court decisions above preclude judicial consideration of the *substance* of NLRB election rules, it does not necessarily follow that courts cannot consider the *procedure* by which such rules are enacted.

ing the Board's procedure in promulgating it. The Second,[28] Third,[29] Fifth,[30] and Ninth[31] Circuits approved the procedure by which *Excelsior* was adopted as well, relying in general on the Board's broad power over representation election proceedings[32] and the Board's discretion to choose whether it will use "rule-making" or "adjudication" procedures.[33] All the above circuits also found that the names and addresses could properly be subpoenaed as evidence under section 11 of the NLRA.[34]

III. NLRB v. WYMAN-GORDON CO.

The Board determined that *Excelsior* required Wyman-Gordon Co. to produce a list of names and addresses for the union's election use and petitioned the courts for enforcement of its subpoena when Wyman-Gordon refused to comply. The Supreme Court could not reach a majority view but seven justices concurred in upholding the Board's decision. In discussing *Excelsior*, the plurality[35] condemned the Board's non-compliance with the rule-making procedures of section 4 of the APA. "There is no warrant in law for the Board to replace the statutory scheme with a rule-making procedure of its own invention."[36] Referring to the specific procedure followed by the Board in *Excelsior*, the plurality observed that it fell short of the substantive requirements of the APA. The plurality stated that the Board could, by adjudication, decide whether such a list was to be required in a particular case. But the Board did not do that in *Excelsior*; it did not even apply its decision to the parties in the adjudicatory proceedings before it. Rather, the Board purported to exercise its quasi-legislative rule-making power. The court further stated that this "*Excelsior* rule," by itself, was not binding on the parties in the instant action.[37] But, as they stated, the Board *could* have decided the names and addresses question in a valid adjudication. And that, according to the plurality, is precisely what the Board did in *Wyman-Gordon*. It "specifically directed" Wyman-Gordon "to submit a list of the names and addresses of its employees."[38] Citing *Waterman*,[39] they held this order valid. The plurality concluded by stating its agreement with those courts of appeals which held the list of

[28] NLRB v. Beech-Nut Life Savers, Inc., 406 F.2d 253 (2d Cir. 1968).

[29] NLRB v. Q-T Shoe Mfg. Co., 409 F.2d 1247 (3d Cir. 1969).

[30] Groendyke Transp., Inc. v. Davis, 406 F.2d 1158 (5th Cir. 1969); Howell Mfg. Co. v. NLRB, 400 F.2d 213 (5th Cir. 1968).

[31] British Auto Parts, Inc. v. NLRB, 405 F.2d 1182 (9th Cir. 1968).

[32] *See* note 27 *supra*.

[33] SEC v. Chenery Corp., 332 U.S. 194 (1947). The proposition may be stated thus: absent specific statutory direction to the contrary, an administrative agency, in its own discretion, can decide whether to attack a particular problem by a general rule-making proceeding or on a case-by-case basis. But it would seem to be presumed that if the latter course is followed the resulting orders will be true "adjudications" between conflicting parties and not statements of only prospective general application and effect.

[34] 29 U.S.C. § 159(d) (1964).

[35] Justice Fortas, joined by Chief Justice Warren and Justices Stewart and White.

[36] NLRB v. Wyman-Gordon Co., 394 U.S. 759, 764 (1969).

[37] A valid rule promulgated by a § 4 proceeding would be binding on all parties to whom it is addressed without need for adjudicatory proceedings. *See* notes 10, 12 *supra*, and accompanying text.

[38] NLRB v. Wyman-Gordon Co., 394 U.S. 759, 766 (1969).

[39] NLRB v. Waterman S.S. Corp., 309 U.S. 206 (1940). *See* discussion in note 27 *supra*.

names and addresses to be evidence within the meaning of section 11 of the National Labor Relations Act.[40]

Three concurring Justices[41] believed "the *Excelsior* practice was adopted by the Board as a legitimate incident to the adjudication of a specific case before it . . . ."[42] Prospective application of the decision was seen as of no importance. Two Justices,[43] dissenting in separate opinions, stated in essence that the *Excelsior* proceeding resulted in an illegal "rule" which cannot be relied on in subsequent Board action.

The four-three-two split, confusing as it is, is made worse by the inconsistency within the plurality opinion. The plurality stated that the *Excelsior* decision was not "adjudication" as it was not applied to the parties before it. Likewise it was not "rule-making" because the Board failed to comply with the requirements of section 4 of the APA. But they held that the "order" directed to Wyman-Gordon—although based solely on the "rule" announced in *Excelsior*—was valid. Since, according to the plurality, the arguments against the substantive validity of this "order" were disposed of by the Board in *Excelsior*, to remand would be meaningless. The anomaly of this reasoning is that an invalid procedure can be determinative of the issue.[44]

The problem is that the plurality was unclear and incomplete in its analysis. They stated, without deciding, that the order to Wyman-Gordon to produce the list was a part of the final disposition of an agency adjudication. The Court erred in this statement. There was no "adjudication" in *Wyman-Gordon*. The regional director issued the order, not after a determination on the instant facts that it was necessary to the fair conduct of the election, but as a matter of course following the *Excelsior* rule.[45] The Board denied review of the regional director's decision as lacking "substantial issues."[46] No section 5 "adjudication" sufficient to support an order was present in this case.

There is, however, one possible way to reconcile the result of this case with the APA and the NLRA. Unfortunately, it was not clearly expressed in any of the opinions. *Wyman-Gordon* involved a *representation election* and a Board subpoena. Representation election proceedings are specifically exempted from the adjudicatory procedures enumerated in section 5 of the APA.[47] Agency subpoenas are authorized on a showing of "general rele-

[40] 29 U.S.C. § 151-90 (1962). *See also* note 27 *supra*, and text accompanying note 34 *supra*.

[41] Justice Black, joined by Justices Brennen and Marshall.

[42] NLRB v. Wyman-Gordon Co., 394 U.S. 759, 770 (1969).

[43] Justices Douglas and Harlan.

[44] Apparently all the Board need do is announce its "rule" prospectively in an "order" terminating an "adjudication," being careful that neither party before it has reason to appeal. (In *Excelsior* both parties "won." The Union won its point as to all future elections and would not want to appeal; the Company won the case and could not appeal.) In a subsequent adjudication the "rule" can be retroactively applied to the parties then before the Board. Since the "substance" of the rule has already been passed upon, to remand would be meaningless.

[45] NLRB v. Wyman-Gordon Co., 394 U.S. 759, 782 (1969) (dissenting opinion by Harlan, J.).

[46] *Id.*

[47] 5 U.S.C. § 1004(6) (1964).

vance and reasonable scope."[48] The NLRA gives the regional director and the Board control over the conduct of these elections with virtually no judicial review.[49] Had the result been put on this basis, consideration of *Excelsior* would have been unnecessary. To resolve the instant case, all that was required was recognition of the regional director's "order" as part of an order to conduct a representation election, over which he and the Board have almost total control, and determination of whether the Board's subpoena power extends to a list of names and addresses of employees.

The concurring Justices argued that in *Excelsior* the Board was adjudicating a dispute between the parties before it. Since the "rule" announced concerned a matter before the Board, it was a valid incident to this adjudication. Whether to accept a new requirement urged by one party and whether, if accepted, to apply it to the other party in the case are *both* valid parts of the adjudicatory function. The Board could consider the company's justifiable reliance on past procedures as reason to apply its decision prospectively only. But as Justice Harlan points out in his dissent, this is precisely the situation in which the procedures of rule-making are demanded. The *Excelsior* rule, according to the Board, was not applied to the parties because it represented so great a change that it would be unfair to do so. When such changes are being considered, *all* interested parties should receive notice and should have the opportunity to submit their views. The general issue should not be permitted to be clouded by the possible presence of unusual facts in a specific case before the Board.

IV. Conclusion

Excelsior is the most obvious attempt yet by the NLRB to make general rules under the cloak of an adjudication. There the Board quite clearly intended to do more than hear a question arising from the conduct of an election, and chose to do so by the less formal and somewhat simplified procedure of adjudication rather than by statutory rule-making. Possibly trying to protect its decision from attack as "arbitrary and capricious," possibly not wanting every election then in progress to have to be started over again, it gave its decision only prospective effect. This is clearly rule-making. A majority of six recognized it as such and would have overturned it had *Excelsior* itself been before the Court. It was not, however, before the Court on its own, and as has been shown, need not have been considered by the Court at all. The consideration given it does indicate, however, that the Court may be willing to look more closely at adjudications used merely as a device for propagation of general rules.

Wyman-Gordon is a quite graphic illustration of the confusion and complexity surrounding judicial review of agency action. A portion of this is no doubt unavoidable. The broad, ambiguous, and overlapping functions and powers of the federal regulatory agencies simply do not fit into neat

[48] Administrative Procedure Act § 6(d), 5 U.S.C. § 1005(c) (1964). The National Labor Relations Act, 29 U.S.C. § 161(1) (1964), authorizes the Board to subpoena material "that relates to any matter under investigation or in question."

[49] *See* note 27 *supra*.

categories capable of individual analysis. Yet a part of the trouble is caused by the courts themselves. For example, issues are clouded when comments are aimed at the "substantive" soundness of Board action. This is simply not a matter which concerns the courts.[50] Consideration of it detracts attention from the questions which should be controlling. In this case those questions would be: (1) What has the Board actually done? (2) By what procedure was it done? (3) Can this combination be sustained under the applicable statutes?

Assuming the interpretation of the plurality opinion expressed in this Note to be accepted, the result of this case would be strictly limited to representation election cases. It would not be precedent in other areas, such as determination of unfair labor practices, as the applicable statutory provisions are somewhat different.

Perhaps significantly, two of the four plurality Justices are no longer on the Court.[51] As the Court's "holding" could possibly be construed and applied in other ways, a prediction as to the outcome of future cases (at any level) would be purely conjectural.

David A. Ives

Securities — Civil Liability for Violation of Exchange Rule

Dobich, an individual broker-dealer operating under the name of Dobich Securities Corporation, contracted with people in Indiana for the purchase of securities. The money he received from his clients was embezzled by Dobich and used to speculate in the stock market on the account of Dobich Securities Corporation. The trading resulted in large losses, and the corporation went into bankruptcy.

Buttrey, the trustee of bankrupt Dobich Securities Corporation, sued Merrill Lynch, Pierce, Fenner & Smith, Inc. to set aside certain transactions that had taken place while Merrill Lynch was the securities broker of the bankrupt. Buttrey alleged that Merrill Lynch had violated New York Stock Exchange rule 405[1] in its dealings with the bankrupt and that this violation was actionable by Buttrey.[2] Specific allegations amounting to

[50] *See, e.g.*, a statement by Justice Fortas for the plurality, 394 U.S. at 767.

[51] Chief Justice Earl Warren and Associate Justice Abe Fortas both resigned from the Court in 1969.

[1] N.Y.S.E. Rule 405 provides:

> Every member organization is required through a general partner or an officer who is a holder of voting stock to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.
>
> (2) Supervise diligently all accounts handled by registered representatives of the organization.

2 CCH NYSE GUIDE ¶ 2405 (1962).

[2] Two other claims were alleged:

> Count II was based on the same factual allegations and alleged that the 'natural result of such course of business by the defendant operated as a fraud or deceit' upon the bankrupt in violation of Section 17 of the Securities Act of 1933 (15 U.S.C. § 77q)

fraud on Dobich's customers by Merrill Lynch were made by Buttrey.[3] On motion by Merrill Lynch for summary judgment, the lower court held that the facts alleged constituted a fraudulent violation of rule 405 which was actionable by Buttrey. *Held, affirmed*: Fraudulent violations of New York Stock Exchange rules that are intended to protect the public are actionable by private parties. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

I. EXCHANGE RULES AND FEDERAL SECURITIES LAW

The Concept of Federal Securities Law. The unique statutory concept of supervised self-regulation by exchanges and dealer associations creates a problem as to whether a claim can be maintained for violation of stock exchange rules. The effect and significance of particular rules may vary with the manner of their adoption and their relationship to the provisions and purposes of the statute and SEC regulations.[4] The main source of implied liability under the 1934 Securities and Exchange Act has been fashioned by the courts under section 10(b) of the Act and rule 10b-5 of the Securities Exchange Commission.[5] Both section 10(b) and rule 10b-5 assert that certain conduct is unlawful, but do not expressly say that any person is liable to another person for violation of these provisions.[6] The

> and rule 10b-5 of the Securities and Exchange Commission (17 C.F.R. § 240.10b-5) promulgated under Section 10 of the Securities and Exchange Act of 1934 (15 U.S.C. § 78j). Count III claimed that defendant knowingly aided, abetted and assisted Michael Dobich in violation of Section 17 of the Securities Act of 1933 and SEC rule 10b-5. Counts II and III also sought recovery of $515,000.

Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 137 (7th Cir. 1969).

[3] The specific allegations were: that Michael Dobich was financially unstable and was a big speculator in securities and commodities; that Dobich's prior personal dealings with Merrill Lynch indicated he was financially irresponsible; that Merrill Lynch had suspended him from trading in commodities because of his erratic trading practices; that despite knowledge of Dobich's personal dealings Merrill Lynch allowed him to open a cash account in the name of the bankrupt, of which he was the sole stockholder and principal officer; that Merrill Lynch authorized the opening of the account without requiring financial statements, bank references, or credit reports as to the bankrupt; that Merrill Lynch did not determine whether the transactions were to be for the bankrupt as principal or agent; that even while knowing that Dobich was trading with his customers' money which had been fraudulently converted, Merrill Lynch changed the bankrupt's account to a margin account; that thereafter Merrill Lynch permitted Dobich to speculate in large stock transactions, the losses from which led to the bankruptcy of Dobich Securities Corporation. *Id.* at 141.

[4] Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181 (2d Cir. 1966).

[5] *See* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 13 (1966).

[6] Section 10(b) of the 1934 Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange to use or employ, in connection with the purchase or sale of any security registered on a national exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1964). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> a. to employ any device, scheme, or artifice to defraud.
>
> . . . .
>
> c. to engage in any act, practice, or course of business which operates or could operate as a fraud or deceit upon any person . . . .

17 C.F.R. § 240.10b-5 (1969).

reasoning behind the imposition of civil tort liability was expressed in *Kardon v. National Gypsum Co.*:[7] "The violation of a legislative enactment by doing a prohibited act, . . . makes the actor liable for an invasion of an interest of another if: (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect . . . ."[8] Today it is settled law that there is an implied private remedy for violation of section 10(b) and rule 10b-5.[9]

The Securities and Exchange Commission has the power to require stock exchanges to adopt rules providing for the expulsion, suspension or discipline of an exchange member for any "conduct or proceeding inconsistent with just and equitable principles of trade."[10] Such rules must be designed to "insure fair dealing and to protect investors."[11] Further, section 19 of the 1934 Securities and Exchange Commission Act gives the SEC power to review, update, and supplement exchange rules.[12] The SEC forbears making new rules of its own in deference to existing exchange rules.[13] Thus, the federal statutory scheme is interwoven with exchange rules.[14] At least one commentator, Lewis Lowenfels,[15] has argued that the interrelation of SEC and exchange rules gives rise to civil liability for violation of certain exchange rules.[16]

Case Law on the Imposition of Civil Liability for Violations of Exchange Rules. The question of whether a private action can be based on violation of an exchange rule is not settled. The leading case is *Colonial Realty Corp. v. Bache & Co.*[17] In that case Colonial Realty alleged violation of a federal right by Bache's failure to act in a manner "consistent with just and equitable principles of trade" and asserted violations of the New York Stock Exchange Constitution and the Rules of Fair Practice of the National Association of Securities Dealers.[18] The controversy arose from

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[7] 69 F. Supp. 512 (E.D. Pa. 1946).

[8] *Id.* at 513, quoting 2 RESTATEMENT OF TORTS § 286 (1939). *See also* 2 RESTATEMENT (SECOND) OF TORTS § 286 (1965).

[9] *See* A. BROMBERG, SECURITIES LAWS: FRAUD—SEC RULE 10b-5, § 2.4(1), at 27-28 (1969), for further rationale and cases supporting imposition of civil tort liability.

[10] Securities Exchange Act § 6(b), 15 U.S.C. § 78f(b) (1964).

[11] Securities Exchange Act § 6(d), 15 U.S.C. § 78f(d) (1964).

[12] Securities Exchange Act § 19, 15 U.S.C. § 78s (1964).

[13] Lowenfels, *supra* note 5, at 28.

[14] *Id.* at 17.

[15] *See* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966); Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on the NASD Rules*, 51 CORNELL L.Q. 633 (1966).

[16]
> Where the SEC has the power of life and death over the rules of an exchange and where, presumably in deference to the policy of encouraging exchange self-regulation, the SEC forbears from adopting its own rules because exchange rules have already preempted the field, it seems only reasonable to conclude that these exchange rules afford private investors the same right they would possess had the SEC promulgated rules identical to those adopted by the exchange.

Lowenfels, *supra* note 5, at 18.

[17] 358 F.2d 178 (2d Cir. 1966).

[18] Article XIV of the Constitution of the New York Stock Exchange and article I, § 2(a) of the Bylaws and article III, § 1 of the Rules of Fair Practice of the National Association of Securities Dealers. *See* 2 CCH NYSE GUIDE ¶ 1651 (1962); CCH NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL ¶ 2151 (1967).

Bache's sales of securities in Colonial's margin account contrary to an alleged agreement between the two that Bache would not require a margin in excess of the requirements of the New York Stock Exchange. Colonial sought to recover its losses, running into millions of dollars, and $100,000 in commissions Bache had collected. Although this was not the first time the Second Circuit had passed on implied civil liability on stock exchange rules,[19] it was the first time the issue was squarely presented to the court.[20] Judge Friendly stated: "A particular stock exchange rule could . . . play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and we would not wish to say that such a rule could not provide the basis for implying a private right of action."[21] However, the court in *Colonial Realty* ruled against imposing civil liability for the violation of an exchange rule: "The consequences of the view urged by Colonial would be so disruptive as to require much more impressive evidence of congressional purpose than we can discern."[22] Judge Friendly reasoned that the disciplinary function of exchanges should be enough to protect the public and that Congress seems to have relied on this exchange function by not expressly making exchange rules actionable.[23]

Colonial Realty has furnished leadership for a number of other cases. In *Hecht v. Harris, Upham & Co.*[24] the court did not pass on whether the violation of a National Association of Securities Dealer's rule[25] was actionable, but held that the plaintiff was barred by estoppel and waiver from asserting this claim.[26] In this case, a widow had entrusted Harris, Upham with an account valued at $508,659 in 1956. By 1964, under Harris, Upham's management, the value of the account had dwindled to $251,308. It was shown that if Harris, Upham had maintained the account as it had originally been transferred to them it would have been worth $1,026,775. The widow sued for damages alleging in part that Harris, Upham had recommended unsuitable securities for the account in violation of article III, section 2 of the Rules of Fair Practice of the National Association of

[19] *See* O'Neill v. Maytag, 339 F.2d 764, 770 (2d Cir. 1964), where an attempt to amend a complaint to make the claim actionable under federal law by alleging violation of an exchange rule was rejected by the court without extensive discussion. This case was cited by Judge Friendly in Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966).

[20] Judge Friendly had before him Lowenfels' writings and specifically mentioned their reasoning. *See* note 16 *supra* for Lowenfels' reasoning for the imposition of implied civil liabilities.

[21] Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966).

[22] *Id.*

[23] *Id.* at 181.

[24] 283 F. Supp. 417 (N.D. Cal. 1968).

[25] National Association of Securities Dealers rules are similar to stock exchange rules in that both are formulated pursuant to the securities acts for the self-regulation of the brokers. Because of this, imposition of civil liability for the violation of one set of rules would logically lead to imposition of civil liability for the violation of the other set of rules.

[26] The court found the plaintiff had sufficient knowledge of the working of the stock market and information that her account was not being handled in accordance with her claimed understanding and instructions, and held she could not be heard to complain that the management of her account was unsuitable for her needs and objectives and contrary to her instructions. Her acquiescence to the acts of the broker made her subject to a defense of estoppel and waiver. Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968).

Securities Dealers.[27] The court reasoned, citing *Colonial Realty*, that although there might be implied civil liabilities for violation of dealer rules:

> [N]o implied civil liability may be predicated on rules which give power to discipline members for certain kinds of misconduct, including merely unethical behavior, which Congress could well not have intended to give rise to a legal claim, e.g., conduct which, although unethical under the association or exchange rules, does not amount to a fraud within the meaning of the fraud provisions of the Act itself.[28]

In applying this test to the facts, the court reasoned that imposing liability might result in good faith recommendations of brokers being overruled in the courts. Again citing *Colonial Realty*, the court stated that the practical consequences of allowing a cause of action for violation of dealer rules might be "considerable." By invoking a rule of estoppel and waiver a difficult issue was avoided.[29]

Mercury Investment Co. v. A.G. Edwards & Sons[30] was an action against a National Association of Securities Dealers member for mishandling an account. As in *Hecht*, the plaintiff alleged a claim on a violation of article III, section 2 of the Rules of the National Association of Securities Dealers.[31] Citing *Colonial Realty* and *Hecht*, the court reasoned that the securities acts were essentially directed at fraud. For a rule to be the basis for implied liabilities it must be shown that it is consistent with the securities acts. Since article III, section 2 applied to merely negligent and unethical acts, it governed a much wider area than that of the securities acts and should not be used as the basis for implied liabilities. The court did indicate that violation of article III, section 2 might be used for evidence in any pendant claim for negligence.[32] These cases and others have come to stand for the proposition that there is no implied liability claim under stock exchange or dealer association rules.[33]

II. BUTTREY v. MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.[34] is the first case to directly hold that violations of exchange rules may be actionable by third parties. This right of action was limited by the court's opinion to cases

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[27] *Id.* at 430. Article III, § 2 of the Rules of Fair Practice of the National Association of Securities Dealers provides: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable ground for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." CCH NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL ¶ 2152 (1967).

[28] Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 431 (N.D. Cal. 1968).

[29] The court allowed recovery on other grounds. Note that Harris, Upham's acts were held to violate section 10b and rule 10b-5. *Id.* at 439-40. *See also* note 6 *supra*.

[30] 295 F. Supp. 1160 (S.D. Tex. 1969).

[31] *See* note 27 *supra*.

[32] Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969).

[33] *See* De Renzis v. Levy, 297 F. Supp. 998, 1001-02 (S.D.N.Y. 1969), where the court rejected plaintiff's reliance on language in *Colonial Realty* to the effect that there was implied civil liability for the violation of exchange rules as being dicta. Pearlstein v. Scudder & German, 295 F. Supp. 1197, 1202 (S.D.N.Y. 1968), refers to *Colonial Realty* in footnote 6 to the effect that there is no implied civil liability under the rule of an exchange.

[34] 410 F.2d 135 (7th Cir. 1969).

of fraudulent violations of exchange rules that are designed to protect the public. Nevertheless, this is a significant development in federal securities law.

The court began its reasoning with *J.I. Case Co. v. Borak*,[35] stating that private suits for damages were impliedly authorized by the Securities Exchange Act of 1934. Judge Friendly's dicta in *Colonial Realty* was quoted to the effect that stock exchange rules can play an integral part in SEC regulation:

> What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on [a] simplistic all-or-nothing basis . . . ; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.[36]

The actual holding in *Colonial Realty* was omitted from the court's opinion. However, by reasoning that there was nothing in the Exchange Act to prevent rule 405 from being actionable, the court evaded the problem of congressional intent. While Congress has not expressly made exchange rule violations actionable, it also has not said they were not actionable. The court supplied very little detail as to how they arrived at this result except to cite Lowenfels. The court adopted Lowenfels' position and decided that "one of the functions" of rule 405 is to protect the public, "so that permitting a private action for its violation is entirely consistent with the purposes of the statute."[37]

The actual holding was that an alleged violation of rule 405 was not actionable "per se" and the court indicated that it was the degree of fraud in the alleged acts that made the rule actionable. Further, the court intimated that negligence or mere errors in judgment might not support a federal cause of action under exchange rules, but that "the facts alleged here are tantamount to fraud on the bankrupt's customers." The court noted: "Until this case is actually tried, it will be impossible to ascertain whether defendant has violated rule 405, and if so, whether the violations justify the imposition of liability."[38] What the court's holding boils down to is that New York Stock Exchange Rules may be actionable when they are designed to protect the public and the violation of them is fraudulent.

Although the court in *Buttrey* did not specifically mention it, the case is distinguishable from *Colonial Realty* and its companion cases, *Hecht* and *Mercury Investment*. The alleged acts in *Buttrey* were of a definitely fraudulent nature, thereby meeting the criteria of *Hecht* and *Mercury Investment* dicta. In *Buttrey* the violation of a specific rule was alleged. This is

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[35] 377 U.S. 426 (1963).

[36] 410 F.2d at 142, quoting Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966).

[37] Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir. 1969). *See* note 16 *supra* for Lowenfels' argument.

[38] 410 F.2d at 143.

distinguishable from *Colonial Realty*, where the violation of a "general catch-all" type of rule was alleged.[39] While the violation of a specific rule was alleged in *Hecht* and *Mercury Investment*, the meaning of the rule there was far less certain than that of rule 405.[40] The alleged facts in *Buttrey* had strong "gut" value that would naturally encourage a judge to "do equity." Furthermore, there is evidence of SEC forbearance as a result of adoption of modifications in rule 405 by the New York Stock Exchange.[41]

III. CONCLUSION

There are a number of disturbing factors about *Buttrey*. Two other claims were alleged on the same set of facts as the rule 405 violation.[42] Both claims were held to be good.[43] This raises the question of whether it was necessary for the court to decide the rule 405 claim as it did. Considering the broad wording of section 10(b) and rule 10b-5 and the fact that it is already established that a private right of action lies for their violation,[44] the rule 405 decision may be meaningless. If stock exchange or dealer association rules are to be actionable only when violation of them is fraudulent, then an action under section 10(b) and rule 10b-5 will probably already lie. Also, a plaintiff alleging a section 10(b) and rule 10b-5 claim does not have to convince the court that the section and the rule were intended for the protection of the public as he does under a stock exchange or dealer association rule claim. It would seem that a claim under a stock exchange or dealer association rule is not as satisfactory a remedy for fraudulent acts by a defendant as a section 10(b) and rule 10b-5 claim. If the permissible range of claims is expanded beyond fraud claims then problems will likely result.

In *Colonial Realty* Judge Friendly pointed out that adoption of civil liability for the violation of exchange rules would be disruptive. The widely accepted practice of arbitrating problems between brokers and their customers would largely be eliminated. The federal courts would be open to many more suits even though the controversy was between citizens of the same state and the amount in question was not of a jurisdictional amount. State courts would be denied the power to adjudicate claims between their own citizens whenever a violation of exchange rules was alleged. The federal courts might have to develop a new body of broker-customer law to handle these new actions despite the fact that the result of the suit might be the same under existing state law.[45]

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[39] *See* note 18 *supra*.
[40] *See* notes 1, 27 *supra* for rule 405 and article III, § 2.
[41] As a result of a study of the securities markets, conducted by the SEC at the request of Congress, the New York Stock Exchange adopted modifications in procedures relating to rule 405. SEC SPECIAL STUDY, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 521, pt. 5, at 54 (1961).
[42] *See* note 2 *supra*.
[43] Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 143-44 (7th Cir. 1969).
[44] *See* notes 6, 9 *supra*.
[45] Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182-83 (2d Cir. 1966). Section 27 of the 1934 Securities and Exchange Act provides for exclusive jurisdiction of the federal courts in federal securities cases. 15 U.S.C. § 78aa (1964).

The court in *Buttrey* seems to have gone further than it needed in order to afford recovery to a plaintiff who had been wronged. If the concept of implied liabilities under stock exchange and dealer association rules is limited to fraudulent actions, in future cases the remedy may be useless. If implied liabilities are extended to cases that do not involve fraud, many of the problems predicted by Judge Friendly may result. In either fraudulent or nonfraudulent actions, courts will be required to look behind the rule to its purpose and, if there has been any SEC forbearance as a result of the rule, on a case-by-case basis. Finally, as in *Buttrey*, courts will be hard put to justify imposition of civil liability for violation of stock exchange or dealer association rules in the face of an apparent lack of congressional intent to do so.

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