

MEMORANDUM

November 28, 1977

TO: Chairman Williams

FROM: The Office of the General Counsel *WSP*

RE: The Commission's authority to prohibit exchange trading of standardized options

Introduction

This is in response to your request that this Office prepare a memorandum concerning the Commission's authority to prohibit exchange trading of standardized options. Because of the nature of the request, and the fact that it was made as the Commission considered the commencement of a comprehensive review of exchange options trading, we assume, for purposes of this memorandum, that you have sought our advice on whether the Commission could prohibit all exchange trading in options if it desired to do so after evaluating the information obtained in the inquiry presently being conducted by the Division of Market Regulation.

Based on this premise, this memorandum contains an analysis of three provisions that might provide a statutory basis for prohibiting or curtailing the exchange trading of options. These provisions are Sections 9(b), 19(c) and 19(h) of the Securities Exchange Act. The memorandum also considers the extent to which such action may be subject to challenge on the asserted ground that it is contrary to the requirements of the due process clause contained in the Fifth Amendment to the United States Constitution.

Section 9(b) of the Securities Exchange Act

Although Section 9(b) of the Securities Exchange Act gives the Commission broad plenary authority to regulate the exchange trading of options, we conclude, based on the language of the statute and the legislative history of the provision, that Congress may not have intended that Section 9(b) be used to prohibit all exchange trading of options. Congress clearly did intend, however, to give the Commission authority to regulate specific abuses that might arise in the context of exchange options trading.

As is set forth in more detail below, Section 9(b) presumably could provide a basis for prescribing conditions for the exchange trading of options that, while not directed expressly at the prohibition of such trading, could have that effect. For example, if the Commission were to prescribe disclosure requirements comparable to those required for a full registration statement filed under the Securities Act, or prescribe trading requirements that, as a practical matter, could not be met within the foreseeable future, the effect would be a de facto prohibition of exchange trading in options. Although our authority to effect such a result should not be open to serious question, there are significant due process, and related, matters that should be taken into consideration.

In this regard, we believe that the Commission's ability to use its authority under Section 9(b) in such a fashion will depend in large measure on the results of the Commission's current investigation of options trading and the degree to which the Commission can establish an adequate factual predicate for any rule it might determine to adopt.

a. Legislative History

Section 9(b) of the Securities Exchange Act makes it unlawful, among other things, to effect "any transaction" on an exchange in puts, calls, straddles or other options "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." ^{1/} This provision gives the Commission broad authority to proscribe transactions in options, provided that the Commission makes the required determination that such action is "necessary or appropriate in the public interest or for the protection of investors."

Early drafts of the bill that ultimately became the Securities Exchange Act would have prohibited all trading of options contracts on an exchange. ^{2/} Section 8(a)(9) of H.R. 7852, for example, was identical to the present Section 9(b) in declaring it unlawful to trade in options, but omitted the phrase "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." ^{3/}

1/ Section 9(b) of the Securities Exchange Act provides:

"It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, 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 —

"(1) any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so; or

"(2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege; or

"(3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege with relation to such security."

2/ See, e.g., Section 8(a)(9) of H.R. 7852.

3/ This language was added in a later draft of the legislation, H.R. 9323.

The early proposals to prohibit entirely the exchange trading of options were prompted by experience that options had been used as a concomitant of pools and other schemes to manipulate the trading of exchange-listed securities. Options were used to insure that members of a pool would have access to a substantial supply of the security they intended to manipulate, generally at bargain prices. If the manipulation proved successful, members of the pool would exercise their options, distribute shares of the stock to the public at inflated prices, and thereby realize large profits. 4/

The potential for abuse inherent in exchange options trading was perceived by each of the congressional committees that considered the legislation that became the Securities Exchange Act. In this regard, the report of the Senate Committee on Banking and Currency, recommending passage of the Securities Exchange Act, stated:

"Many of the most flagrant abuses upon stock exchanges would not be possible without the aid of options. They are indispensable concomitants of every pool operation designed to distribute stock at an increased price. Enormous profits have been made by operators who traded against options without incurring the slightest risk or obligation." 5/

The report of the House Committee on Interstate and Foreign Commerce concerning the bill expressed similar concern.

"The granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations, because the granting of these options permits large-scale manipulations to be conducted with a minimum of financial risk to the manipulators. * * * The connection of pool activity with the option has recently been recognized in the rules of the New York Stock Exchange. As it is not always easy to trace and prove manipulative activity, it is necessary to rid the market of devices which commonly accompany or cloak these activities." 6/

As noted above, these concerns were reflected in early drafts of the legislation that proposed to make all exchange trading of options unlawful. Congress did not provide a detailed explanation, however, for the subsequent revision of the provision that made such trading unlawful only in contravention

4/ See Sen. Comm. on Banking and Currency, "Stock Exchange Practices," S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934) (the "Pecora Commission Report"). See also, Twentieth Century Fund, Inc., Stock Market Control (New York, D. Appleton - Century Co., Inc., 1934).

5/ S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

6/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10-11 (1934).

of such rules and regulations as the Commission might prescribe. 7/ It appears that the change was based upon the testimony of persons associated with the securities industry during the hearings concerning the proposed legislation. These persons testified to the effect that, despite the manipulative purposes for which options had been employed, there were also legitimate aims to be furthered by exchange trading in options. For example, Richard C. Whitney, the President of the New York Stock Exchange, stated:

"Subsection [8(a)]9 prohibits all forms of option contracts. The purpose of including such a severe prohibition was undoubtedly the prevalent belief that options have customarily been used as a means of unfairly influencing market price in connection with manipulative pools. This does not justify, however, an arbitrary prohibition on all forms of option contracts. Options which are used for manipulation might well be prohibited, without preventing the use of options for legitimate and proper purposes." 8/

An additional consideration that induced the Congress to permit options trading subject to Commission regulation was a lack of understanding of options and the implications of a statutory ban on the trading of options. As Congressman Mapes explained, the revised provisions contained in H.R. 9323 gave the Federal Trade Commission:

"jurisdiction to prescribe rules and regulations to control and govern transactions relating to puts, calls, straddles, selling short, sales against the box, and some other things of that kind which the committee felt that it did not understand well enough to justify it in prohibiting altogether or limiting too rigidly * * *." 9/

He added that, for this reason, the regulation of such transactions was "left to the discretion of the Federal Trade Commission." 10/

7/ In the later drafts of the legislation, prior to the inclusion of a provision to establish the Securities and Exchange Commission, the Federal Trade Commission would have been entrusted with the authority to regulate the trading of options on an exchange. See, e.g., H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934).

8/ Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6632 (1934).

9/ 78 Cong. Rec. 8140 (May 2, 1934).

10/ Id.

The delegation of authority to adopt rules concerning the trading of options on an exchange, first to the Federal Trade Commission and then the Securities and Exchange Commission, was presumably thought to be the best way to eliminate the manipulative use of options, while preserving opportunities for their legitimate use. The House Report on H.R. 9323 stated, for example:

"Subsection [8]b is concerned with the use of options in connection with transactions on national securities exchanges. Options and trading against options are the usual concomitants of pool operations. Inasmuch, however, as it has been urged that all options are not affected with the manipulative taint it is made unlawful to trade in or against options only when in violation of such rules and regulations as the Commission may deem necessary in the public interest or for the protection of investors." 11/

Similarly, the report of the Senate Committee concerning the legislation stated:

"The impropriety of practices such as 'pegging' or fixing or stabilizing the price of a security has received most careful consideration by the committee. The committee recommends that such practices be not abolished by statute but subjected to regulation by the Commission. In like manner, the subject of options has been left with the Commission for regulation." 12/

b. Discussion

The fact that Congress, having heard testimony that at least some options trading ought to be permitted, decided to give the Commission authority to regulate and control the trading of options, militates against the conclusion that the Commission may order an outright ban on the exchange trading of options. In this regard, it appears significant that Section 9(b), standing alone, could easily be construed as if it read: "It shall be lawful to effect transactions in options on an exchange unless the Commission finds it necessary or appropriate in the public interest or for the protection of investors to prescribe rules and regulations that curtail the trading of options."

This is not to say that the Commission may not adopt a rule that might have the effect of prohibiting all trading of options on an exchange, but the foregoing does emphasize the importance of establishing an adequate factual predicate for the adoption of such a rule. In this regard, it is

11/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934) (emphasis added).

12/ S. Rep. No. 792, 73d Cong., 2d Sess. 8-9 (1934).

axiomatic that there must be a reasonable relationship between the facts and circumstances involved and any rule that the Commission may promulgate concerning the trading of options. 13/ Thus, whether the Commission may prohibit, or curtail, the trading of options on an exchange consistent with Section 9(b) is ultimately dependent upon whether the Commission is able to determine that there is a sufficient factual predicate to support a rule of that character.

The broad authority conferred upon the Commission by Section 23(a) of the Securities Exchange Act, the general rulemaking provision, would provide additional support for the adoption of a rule that might prohibit or curtail the exchange trading of options. That provision declares that the Commission "shall * * * have power to make such rules and regulations as may be necessary for the execution of the functions vested in * * *" it by the provisions of the Act, including those contained in Section 9(b). Thus, if the facts revealed by the Commission's current investigation of exchange options trading should warrant a determination that prohibiting or curtailing such trading is "necessary for the execution of the * * *" Commission's functions under Section 9(b), the Commission could base its action on the authority provided by both provisions.

In this regard, there is some authority for the proposition that conduct made subject to regulation by statute may be prohibited where an administrator makes an express determination that "measures short of prohibition * * * cannot accomplish the relevant purposes * * * of the statute" Gemsco, Inc. v. Walling, 324 U.S. 244, 248-251 (1945); and see, American Trucking Association, Inc. v. United States, 344 U.S. 298, 308-312 (1953). An argument could be made, on this basis, that the authority to "regulate" exchange options trading pursuant to Section 9(b) encompasses the authority to prohibit such trading in appropriate circumstances. 14/

Under these circumstances, it appears that the promulgation of a rule, pursuant to Section 9(b), would be well within the Commission's delegated authority to the extent that such a rule may be directed at curtailing identifiable abuses in the exchange trading of options. To the extent that the Commission may be able to identify certain abuses as inherent in the exchange trading of options, and further determine that regulation is impracticable, an argument could be made for the proposition that the Commission has authority to prohibit the exchange trading of standardized options. A rule of that character would presumably be more difficult to sustain, however, because

13/ See n. 25 infra. As the United States Court of Appeals for the District of Columbia Circuit declared in International Union (UAW) v. National Labor Relations Board, 459 F. 2d. 1329, 1339 (1972), "Administrative agencies are * * * required to obey the minimum requirements of rationality, see, e.g., Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 * * * (1968) and due process, see, e.g., Ohio Bell Telephone Co. v. Public Utilities Comm'n of Ohio, 301 U.S. 292, 301-305 * * * (1937)."

14/ In a sense, this is the rationale we have employed in preparing temporary Securities Exchange Act Rule 9b-1(T), which would prohibit any further expansion of exchange options trading until a complete study of the exchange options markets can be completed. See Securities Exchange Act Release No. 14056 (Oct. 17, 1977).

it would be more difficult to establish a factual predicate for the proposition that a prohibition, as distinguished from the regulation of specific abuses, is necessary. This difficulty is compounded by the fact that, since 1973, exchange options trading has existed without the establishment of a compelling need to prohibit such trading completely.

Between these two alternatives, there is a third possibility. A rule promulgated for the purpose of curtailing a specific abuse or abuses may have the effect, because of the nature of the abuses involved, and the difficulties inherent in complying with the rule, of prohibiting the exchange trading of options. If a more limited rule directed at curtailing specific abuses would have the effect of prohibiting exchange options trading, there would be no need for the Commission to consider an outright ban on such trading or to attempt to meet the heavier burden of justification that a prohibition would entail.

In summary, we believe that use of the authority provided by Section 9(b) of the Securities Exchange Act must be based on an adequate factual predicate and that, as a general matter, it would be easier to sustain a rule or rules directed at identifiable abuses than an outright ban on the exchange trading of options. We recognize that the abuses described by the Commission in announcing that it would conduct a comprehensive investigation of exchange options trading are potentially so pervasive and so inherent in such trading, that the Commission could reasonably determine that it is necessary to adopt a rule prohibiting exchange options trading. ^{15/} The extent to which the Commission may exercise its authority under Section 9(b), however, is ultimately dependent upon the results of that investigation and the Commission's evaluation of the information obtained in that inquiry.

Section 19(c) of the Securities Exchange Act

An alternative to Section 9(b) exists in new Section 19(c) of the Act, which was added by the Securities Act Amendments of 1975 (hereinafter referred to as "the 1975 Amendments"). Section 19(c) gives the Commission plenary authority to regulate the activities of exchanges by abrogating or amending the rules adopted by self-regulatory organizations. In this regard, the provision states that the Commission:

"may abrogate, add to, and delete from * * * the rules of a self-regulatory organization * * * as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to the requirements of * * * [the Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of * * * [the Act]."

^{15/} See Securities Exchange Act Release No. 14056 (Oct. 17, 1977).

a. Legislative History of Section 19(c)

The legislative history of Section 19(c) reflects that Congress intended to "give the Commission authority to amend the rules of self-regulatory organizations * * * in any manner in furtherance of the purposes of the Exchange Act" (emphasis added). ^{16/} The Senate report explaining the provision adds that

"After a specified procedure, if the SEC deems a change in a self regulatory organization's rules to be necessary or appropriate in the public interest or for the protection of investors, to insure the fair administration of self-regulatory organizations, or to conform the rules of self-regulatory organizations to the applicable registration requirements it may, by rule, effect the change." ^{17/}

The procedures the Commission is required to follow in order to change the rules of a self-regulatory organization include: (1) publishing notice of the proposed rulemaking in the Federal Register, including the text of the proposed amendment, a statement of the Commission's reasons for believing that the change is appropriate and any facts pertinent to the rulemaking; (2) providing an opportunity for interested persons, in writing and in person, to express their views concerning the proposal; and (3) publishing an explanation of its reasons for any final action changing the rules of a self regulatory organization, including an identification of any facts the Commission considered in making its determination and its conclusions as to any facts which were disputed in the rulemaking. ^{18/} Apart from these specific requirements, the Commission's action would be governed by the requirements in the Administrative Procedure Act for notice-and-comment type rulemaking (see 5 U.S.C. 553).

The legislative history reflects that Section 19(c) can provide an independent source of authority for the Commission to prohibit or curtail exchange trading of options. In this regard, the Senate report concerning the 1975 Amendments states:

"Where the SEC has direct authority with respect to a specific subject matter and a self-regulatory organization also exercises authority in the area, the SEC may change regulatory policy in any one of three ways: (1) by promulgating its own substantive

^{16/} S. Rep. No. 94-75, 94th Cong., 1st Sess. 131 (1975).

^{17/} Id.

^{18/} Id.

rule preempting self-regulatory rules on the subject, e.g., Rule 10a-1 concerning short sales; (2) by promulgating a rule under its grant of substantive authority which imposes conditions on the exercise of self-regulatory jurisdiction in the area or the utilization of self-regulatory facilities, e.g., Rule 19b-1 concerning options trading and Rule 11b-1 concerning specialist trading; or (3) by utilizing section 19(c) to force the self-regulatory organization to change its rules." 19/

b. Discussion

Section 19(c) may provide broader authority to deal with exchange trading of options because the focus of the provision differs from that of Section 9(b). As we have seen, a rule promulgated under Section 9(b) to prohibit or curtail the exchange trading of options would presumably require a factual predicate based on identifiable abuses arising in the context of such trading. And, this determination would also have to be based on a judgment that such rule is "necessary or appropriate in the public interest or for the protection of investors." Section 19(c), in contrast, would require the Commission to determine only that a proposed amendment to the rules of a self-regulatory organization is "necessary or appropriate * * * in furtherance of the purposes of * * *" the Securities Exchange Act. 20/

Although the Commission would need a factual predicate sufficient to establish a reasonable nexus between the relevant circumstances and a rule change that would have the effect of prohibiting or curtailing exchange options trading, and comply with the procedural requirements prescribed in Section 19(c), the Commission's discretion appears much broader under Section 19(c) than under Section 9(b). Moreover, Section 19(c) does not appear to be susceptible to an interpretation that a prohibition or curtailment of exchange options trading is inconsistent with the language of the statute. In this regard, the legislative history expressly states that the Commission may use its authority under Section 19(c) as an alternative to the regulation of exchange options trading by means of former Rule 9b-1 promulgated under Section 9(b).

As in the case of Section 9(b), a definitive answer as to whether the Commission may prohibit the exchange trading of options depends upon the results of the Commission's pending investigation. Assuming, however, that the investigation will provide an adequate factual predicate for the promulgation of rules prohibiting or curtailing the trading of options on exchanges, we believe Section 19(c) provides the most effective approach to achieving that result and the approach that would be least vulnerable to attack in the courts.

19/ Id.

20/ The Commission's use of its authority under Section 19(c) of the Securities Exchange Act could be buttressed by reliance on the general rulemaking authority contained in Section 23 of the Act. See supra, p. 6.

In this regard, it is significant that the Commission repealed former Rule 9b-1 following enactment of the 1975 amendments, and replaced that rule with Rule 19b-4, 17 CFR 240.19b-4. ^{21/} Although the Commission's release did not articulate why the promulgation of new Rule 19b-4 made former Rule 9b-1 unnecessary, the two actions, taken together, apparently were based on the premise that new Rule 19b-4 obviated the necessity of retaining former Rule 9b-1. Thus reliance on Section 19(c) would appear to be consistent with the Commission's present approach to the regulation of exchanges options trading.

Section 19(h) of the Securities Exchange Act

The third statutory provision which may provide a basis for prohibiting or curtailing the exchange trading of options is Section 19(h) of the Securities Exchange Act. That provision provides, in pertinent part, that the Commission:

"is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of * * * [the Act], to suspend for a period not exceeding twelve months or revoke the registration of such self-regulatory organization, or to censure or impose limitations upon the activities, functions, and operations of such self-regulatory organization, if * * * [the Commission] finds, on the record after notice and opportunity for hearing, that such self-regulatory organization has violated or is unable to comply with any provision of * * * [the Act], the rules and regulations thereunder, or its own rules or without reasonable justification or excuse has failed to enforce compliance * * * with any such provision by a member thereof or a person associated with a member thereof * * *."

^{21/} Former Rule 9b-1 prohibited transactions on an exchange in puts, calls, straddles and other options except in accordance with a plan established by the exchange that the Commission had declared effective as being necessary or appropriate in the public interest or for the protection of investors (see Securities Exchange Act Release No. 10552 (Dec. 13, 1973)). New Rule 19b-4 provides, inter alia, procedures for self-regulatory organizations to file proposed rule changes and to give notices as to stated policies, practices, and interpretations which a self-regulatory organization believes may be characterized as not constituting a rule (see Securities Exchange Act Release No. 11604 (Aug. 19, 1975)).

Although this provision expressly provides that the Commission may place limitations on the "activities, functions and operations of * * * an exchange in an appropriate case, we believe there are significant disadvantages that would limit the usefulness of this provision as a vehicle for prohibiting or curtailing the exchange trading of options.

The Commission could take such action, for example, only after finding "on the record after notice and opportunity for hearing, that * * * [an exchange, *inter alia*] has violated or is unable to comply with any provision of * * * [the Act], the rules or regulations thereunder, or its own rules * * *." In addition, use of Section 19(h) would require the Commission to make specific allegations of violative conduct against particular exchanges in a quasi-judicial proceeding, as distinguished from a quasi-legislative rulemaking proceeding. Such an adjudicatory proceeding does not appear as well-suited as notice-and-comment rulemaking to dealing with the problems that prompted the Commission to undertake a comprehensive review of exchange options trading.

a. Legislative History of Section 19(h)

The legislative history concerning Section 19(h) indicates that the provision is broadly intended to "enhance the oversight powers of the Commission and * * * significantly increase the regulatory options available to * * * deal with perceived self-regulatory shortcomings."^{22/} In this regard, the Senate report concerning the provision declares that Section 19(h) authorizes the Commission

"by order and upon appropriate findings, to censure and place restrictions on the activities, functions, and operations of a self-regulatory agency. These powers are in addition to suspension and deregistration and are intended to provide more usable sanctions than the SEC's traditional "big stick."^{23/}

The legislative history also reflects that the Commission may "take appropriate action directly against any self-regulatory organization upon a finding that it had failed to enforce its own rules or failed to enforce the Exchange Act or the rules thereunder."^{24/}

^{22/} S. Rep. No. 94-75, 94th Cong., 1st Sess. 34 (1975).

^{23/} *Id.* We have considered, but rejected, the possibility that the Commission could partially suspend or revoke the registration of an exchange. The assertion of authority to partially suspend or deregister an exchange appears inconsistent with the statutory declaration that the Commission may suspend or revoke "the registration" of an exchange. (emphasis added) In addition, there would appear to be no need to advance such a tenuous construction of the statute in view of the Commission's broad authority under Section 19(c) to take action short of suspension or revocation.

^{24/} S. Rep. 94-75, 94th Cong., 1st Sess. 35 (1975).

b. Discussion

Section 19(h) has the advantage of expressly providing that the Commission may "impose limitations upon the activities, functions, and operations of * * * an exchange if the Commission should find, "on the record after notice and opportunity for hearing," inter alia: (a) that an exchange "has violated or is unable to comply with any provisions of * * * [the Act], the rules and regulations thereunder, or its own rules * * *; and (b) that such action "is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the * * * [Act]". This authority would provide an ample basis for prohibiting or curtailing the exchange trading of options in an appropriate case.

We believe there would be disadvantages in the use of Section 19(h), however, that outweigh the express authorization to limit "the activities, functions and operations of * * * an exchange. Section 19(h) could be used only if the circumstances reflect that an exchange "has violated or is unable to comply with the * * *" provisions referred to above, and then only in the context of an on-the-record adjudicatory proceeding. Insofar as the Commission may prefer not to allege such shortcomings on the part of an exchange in an adversarial context, this alternative may have limited usefulness. This would be particularly true in cases where the Commission could achieve a comparable result by means of rulemaking under Sections 9(b) or 19(c).

There are other difficulties associated with the use of Section 19(h). An adjudicatory proceeding instituted pursuant to that provision might not permit the Commission to take remedial action with respect to abuses in exchange options trading that are caused by the activities of third persons who are not members of an exchange or associated with an exchange member. In addition, an administrative proceeding instituted pursuant to Section 19(h) would probably involve the issue of whether the Commission must justify the imposition of sanctions on the basis of clear and convincing evidence, cf. Collins Securities Corp. v. Securities and Exchange Commission, [Current] CCH Fed. Sec. L. Rep. ¶96,122, C.A. D.C., (Aug. 12, 1977, as modified, Sept. 23, 1977).

For these reasons, we believe a notice-and-comment rulemaking proceeding is better adapted to dealing with the problems described in the Commission's recent release announcing the current investigation of exchange options trading. Moreover, we do not believe the Commission should use its authority under Section 19(h), in effect, as a means of promulgating a general rule that that would serve to prohibit or curtail exchange options trading. Rather, we believe that authority should be reserved for cases in which the Commission has reason to believe that an exchange has engaged in culpable conduct and that remedial action may be warranted on the basis of that conduct, see Securities Exchange Commission v. Chenery Corporation, 332 U.S. 194, 201-203 (1947).

The Due Process Considerations

It must be recognized that the prohibition or curtailment of exchange trading of options might raise questions with respect to the applicability of the due process clause of the Fifth Amendment. In this regard, such action could result in substantial losses for the exchanges that are presently providing a market for the trading of standardized options; the CBOE, which trades exclusively in such options, might be forced to go out of business; and many brokerage firms, board brokers and market makers might lose a substantial portion of their income.

Nevertheless, although we are aware of the implications for the exchanges, and sensitive to the need to proceed with caution, we do not perceive due process considerations as presenting an insuperable obstacle to the prohibition or curtailment of exchange options trading, provided that the Commission is able to establish a reasonable nexus between the facts and circumstances deemed to require regulatory action and the means chosen to accomplish that end. In this regard, whether the due process issue is perceived as raising a question of substantive, as distinguished from procedural, due process, or of a "taking" of property without just compensation, we believe the Commission's action may be sustained as long as it is reasonably related to a legitimate regulatory objective.

a. Substantive Due Process

The leading case with respect to substantive due process is Nebbia v. New York, 291 U.S. 502, 525 (1934), where the Supreme Court declared, in the context of a state regulation of milk prices:

"The Fifth Amendment, in the field of federal activity, and the Fourteenth, as respects state action, do not prohibit governmental regulation for the public welfare. They merely condition the exertion of the admitted power, by securing that the end shall be accomplished by methods consistent with due process. And the guaranty of due process, as has often been held, demands only that the laws shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained."

The Court further stated, 291 U.S. at 537:

"[A] state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its pur-

pose. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose, and are neither arbitrary nor discriminatory, the requirements of due process are satisfied * * *."

In West Coast Hotel Co. v. Parrish, 300 U.S. 379, 399 (1937), the Supreme Court reiterated this standard in the context of a state law that prescribed minimum wages for women:

"The legislature had the right to consider that its minimum wage requirements would be an important aid in carrying out its policy of protection. * * * Legislative response to that conviction cannot be regarded as arbitrary or capricious and that is all we have to decide. Even if the wisdom of the policy be regarded as debatable and its effects uncertain, still the legislature is entitled to its judgment."

Since Nebbia and West Coast Hotel Co., the courts have generally taken a "hands-off" approach when regulatory statutes have been challenged on substantive due process grounds. For example, in Williamson v. Lee Optical Co., 348 U.S. 483, 486 (1955), the Supreme Court reversed a district court ruling holding that a state law that forbade opticians from fitting or duplicating lenses without a prescription from an ophthalmologist or optometrist was "neither reasonably necessary nor necessarily related to the end sought to be achieved * * *." In this regard, the Court declared:

"The day is gone when this Court uses the Due Process Clause * * * to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought * * * We cannot say that the regulation has no rational relation to the objective [of professionalizing eye treatment] and therefore is beyond constitutional bounds."

Id., 348 U.S. at 488. In short, the Supreme Court has made clear that it is not the function of the courts to evaluate the wisdom of a regulatory measure, but only to determine whether there is any rational basis for the regulatory action of which review is sought. The continued vitality of this line of cases is reflected in Day-Brite Lighting, Inc. v. Missouri, 342 U.S. 421 (1952); Ferguson v. Skrupa, 372 U.S. 726 (1963); and North Dakota State

State Board of Pharmacy v. Snyder's Drug Stores, Inc., 414 U.S. 156 (1973); cf. Pittsburgh v. Alco Parking Corp., 417 U.S. 369 (1974).

b. The "Taking-Regulatory" Distinction

There may be some question, however, as to whether the prohibition or curtailment of exchange options trading might constitute a "taking" of property within the meaning of the Due Process Clause of the Fifth Amendment. The general rule was stated by Mr. Justice Holmes in Pennsylvania Coal Co. v. Mahon, 268 U.S. 393, 415 (1922): "[W]hile property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."

Although the language used by Mr. Justice Holmes might suggest that a Commission rule prohibiting or curtailing exchange options trading could be challenged as a "taking," the two leading cases in recent years concerning the "taking-regulatory" distinction have upheld challenged governmental action. Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962); Pittsburgh v. Alco Parking Corp., 417 U.S. 369 (1974). In each of these cases, the Supreme Court held that the requirements of the due process clause were satisfied if there was a reasonable basis for the governmental action.

In Goldblatt, it was argued that a town "safety" ordinance that regulated dredging and pit excavations prevented the operators of a sand and gravel pit from continuing their business, 369 U.S. at 590-591. It was conceded that "the ordinance completely prohibits the beneficial use to which the property has previously been devoted," Id. at 592. Although the Court stated that "governmental action in the form of regulation cannot be so onerous as to constitute a taking which constitutionally requires compensation * * *," Id. at 594, the Court indicated that it was not disposed to overturn government actions on this basis. Instead, it pointed out that in cases involving the exercise of "police powers": "Except for * * * the familiar standard of 'reasonableness,' this Court has generally refrained from announcing any specific criteria," Id. at 594. The Court added, Id. at 595, "Even this rule is not applied with strict precision, for this Court has often said that 'debatable questions as to reasonableness are not for the courts but for the legislature * * *,'" Id. at 595 (citation omitted).

In Pittsburgh, the operators of certain commercial parking lots contended that a twenty per cent tax on their gross receipts constituted an unconstitutional "taking". The Supreme Court upheld the tax in an opinion that declared, inter alia, 417 U.S. at 373:

"[T]he Court has consistently refused either to undertake the task of passing on the 'reasonableness' of a tax that is otherwise within the power of Congress or of state legislative authorities, or to hold that a tax is unconstitutional because it renders a business unprofitable."

The opinion added, 417 U.S. at 374:

"The premise that a tax is invalid if so excessive as to bring about the destruction of a particular business * * * [has] been uniformly rejected as furnishing no juridical ground for striking down a taxing act."

c. Conclusion

Although we recognize that the foregoing cases do not involve the exercise of authority by an administrative agency such as the Commission, the principles reflected in those opinions have been applied in cases involving federal administrative agencies. see e.g., Federal Power Commission v. Natural Gas Pipeline Co. 315 U.S. 575, 585-586 (1942); Permian Basin Area Rate Cases. 390 U.S. 747, 769-770 (1968). We believe the same principles would be applicable to judicial review of any rule the Commission might adopt to prohibit or curtail exchange options trading. As long as the Commission acts pursuant to the authority delegated to it by the federal securities laws, establishes an adequate factual predicate for the proposition that regulatory action is "necessary or appropriate" in the public interest or for the protection of investors, and chooses means that are reasonably related to eliminating or curtailing identifiable abuses, we believe the Commission's action would be consistent with the requirements of the due process clause of the Fifth Amendment. 25/

25/ This analysis is consistent with Section 25(b)(4) of the Securities Exchange Act, which governs the scope of review in cases involving the Commission's rulemaking authority:

"The findings of the Commission as to the facts identified by the Commission as the basis, in whole or in part, of the rule, if supported by substantial evidence, are conclusive. The court shall affirm and enforce the rule unless the Commission's action in promulgating the rule is found to be arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law; contrary to constitutional right, power, privilege or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or without observance of procedure required by law."

In addition, the Administrative Procedure Act contains similar provisions governing the scope of review of agency action, see 5 U.S.C. 706.

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