Book Reviews

The Random Road to a New Suitability


Reviewed by Peter J. Barack†

I

Self-described as a how-to-do-it book, *A Random Walk Down Wall Street*¹ may better be characterized as a how-not-to-do-it book. A Wall Street investment banker turned academician, Professor Malkiel reviews the traditional methods of stock valuation before debunking them with the random walk hypothesis.² This hypothesis asserts, in its weak form, that knowledge of past stock price movements can be of no help in determining future stock price movements. In its strong form, it asserts that the market so efficiently digests any relevant investment information as to eliminate the presence of any undervalued securities. If, as Professor Malkiel stresses, the empirical evidence strongly supports the random walk theory, certain conclusions may be said to follow. First, charting and the analysis of past price performance cannot generate an investment strategy that outperforms the market. Second (and perhaps more surprising to those unfamiliar with the random walk literature), fundamental analysis—the attempt to measure a stock’s intrinsic value—will be equally unrewarding. Accordingly, the Wall Street professionals (dubbed SuperAnalysts by Professor Malkiel) must be unable consistently to outperform the stock market.

The primary question for any reader of this book will be: How can an investor make rational investment decisions? The options available to the investor are limited. He may invest the discretionary portion of his savings with an institutional investor, follow the advice

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¹. B. Malkiel, A RANDOM WALK DOWN WALL STREET (1973) [hereinafter cited by page number only].

². For a discussion of the random walk hypothesis, see generally V. Brudney & M. Chirelstein, CASES AND MATERIALS ON CORPORATE FINANCE 1112-23 (1972); THE RANDOM CHARACTER OF STOCK MARKET PRICES (P. Cootner ed. 1964); A. Rayner & J. Little, HIGGLEDY, PIGGLEDY GROWTH AGAIN (1966).
of a trusted broker or investment advisor, construct a portfolio with some sort of random device (as, for example, the proverbial dart-throwing blindfolded chimpanzee),\(^3\) or follow his own choices or some system such as the Malkiel Method set out at the end of *A Random Walk*.*4* Clearly, Professor Malkiel believes that the random walk hypothesis rules out the first two choices.*5* Because professional money managers cannot beat the market averages, the value of such advice must be questioned. Moreover, and more ominously, the specter of an inherent conflict of interest*6* is brought forward in that brokers and mutual fund salesmen earn their keep by selling securities rather than by giving good advice. Because the third alternative will be unacceptable to most investors,*7* the individual investor must rely on his own decisionmaking abilities as assisted by the Malkiel Method*8* and others.

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3. Although no vehicle for investing in a market portfolio now exists, the recently registered Index Fund of America, Inc., a new mutual fund, plans to invest in all 500 common shares listed in Standard & Poor's 500 Corporate Stock Price Index. Wall St. J., Feb. 25, 1974, at 5, col. 3. Because this fund has a minimum purchase level of $1 million, it does not meet Professor Malkiel's suggestions for the individual investor of a no-load, minimum management fee mutual fund which purchases and holds the stocks making up the stock market averages. Pp. 226-27.

4. An investor also could choose the most efficient investment portfolio which maximizes his utility. Although in theory a position of maximum utility can be attained, in practice it is difficult, if not impossible, to determine either the frontier of efficient investment portfolios or an individual's utility function. See generally H. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959); Tobin, Liquidity Preference as Behavior Towards Risk, 25 REV. ECON. STUD. 65 (1968). However, some guidelines can be distilled from this literature on capital asset pricing models. See, e.g., Cohen, The Suitability Rule and Economic Theory, 80 YALE L.J. 1004 (1971).

5. Professor Malkiel does concede that a mutual fund—preferably a no-load, closed end fund selling at a substantial discount—may well be an appropriate investment vehicle for a small investor with less than $20,000 in investable funds. The advantages of such a fund for the small investor include lower transaction costs, lower costs for record maintenance, and the possibility of greater market diversification and, hence, less unsystematic risk. Pp. 202, 210-27.


7. An investor could employ some random decisionmaking process to construct his investment portfolio, but any such process would be unlikely to yield an efficiently diversified portfolio for the small investor unable to purchase 15 to 20 different securities. An investment in a market portfolio, defined as investing in all listed securities or in all those securities making up the Standard & Poor's 500 Corporate Stock Price Index or some other market index, is not strictly a randomly selected portfolio. Nonetheless, this also cannot be considered a feasible investment strategy. Not only would the amount of money required be unduly large for most individual investors, but also the transaction costs could be uneconomic.

8. The Malkiel Method sets out four investment rules:
Rule 1: Confine stock purchases to companies that appear able to sustain above-average earnings growth for at least five years.
Rule 2: Never pay more for a stock than can reasonably be justified by a firm foundation of value.
Rule 3: It helps to buy stocks whose stories of anticipated growth are ones on which investors can build castles in the air.
Rule 4: Trade as little as possible: in general, hold on to the winners and sell the ones that don't work out. Pp. 240-44.
The Malkiel Method is, unfortunately, no panacea. Moreover, it is admittedly inconsistent with the random walk hypothesis espoused throughout the body of the book. For example, Malkiel Method Rule 1 directs the investor to select only those securities with above average earnings potential and Rule 2 admonishes against paying more for a security than its intrinsic value. The Malkiel Method, however, does not tell the reader how such evaluations can be accurately made. Indeed, it requires the individual investor to do just those things that professional money managers are supposedly unable to do or, if one accepts the strong form of the random walk hypothesis, that are impossible to do.

The justification underlying the Malkiel Method is somewhat elusive. At first it appears that the Method is an exhortation to play "The Money Game," to gamble in the hope that luck will carry the day. After all, unlike Las Vegas where the odds are against you, here performance is measured against the market index which has averaged a positive 9.8 percent over the long run. And the old maxim (Malkiel Method Rule 4) "Ride the Winners and Sell the Losers" may help the investor limit his downside exposure.

More importantly, however, market imperfections may create opportunities for a quick dash to a successful investment. For example, although the market is an efficient mechanism for translating known information about a company into its price, the possibility always exists of discovering and acting upon a special situation through superior analysis of existing information. However, one may not be able to do this on a consistent basis. Moreover, such superior analysis often may be based on some form of quasi-inside information which may impose a duty to refrain from trading until wider public dissemination of such information takes place. A second, more interesting, example may be found in the form of the present two-tier market structure. The present concentration of interest and trading activity on a select group of "blessed" securities may indicate the

11. Cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), cert. denied, 394 U.S. 976 (1969). The recent Equity Funding Corp. scandal involves a less clear example of trading on inside information. There, a financial analyst passed on a recommendation to his clients to sell Equity Funding stock after hearing rumors of insurance fraud from a former employee of the company. See Wall St. J., March 7, 1974, at 15, col. 2.
market's inability to digest relevant information on other securities. If this is so, an opportunity exists to purchase undervalued securities in the lower tier and profit upon their appreciation in price once this imperfection on the demand side is resolved.¹³

II

Professor Malkiel's focus on advising the individual investor is somewhat misdirected. Today, institutional investors control about 45 percent in value of all securities listed on the New York Stock Exchange and account for over 68 percent in value of all public trading on the Exchange.¹⁴ This long-term trend towards increased savings intermediation is unlikely to be slowed by Professor Malkiel's admonitions against professional money managers. Consequently, a more appropriate concern would be how to hold such money managers and their investment decisions to the best interests and investment objectives of their ultimate beneficiaries: the fund shareholder, the depositor, and the policyholder, who all have a direct interest in the character of the investment portfolio of their respective investment company, bank, or insurance company.

The investment decisionmaking of many institutional investors takes place within an environment of extensive federal and state control.¹⁵ For example, state statutory legal lists restrict the investment powers of insurance companies,¹⁶ savings banks,¹⁷ and state and local

¹³. The two-tier market may exist because of such reasons as the relative decline in importance of individual traders and the “herd” instinct orientation of many institutional traders. If the lower multiples at which many stocks in the lower tier are selling represent a disequilibrium position, it may be resolved as buyers become aware and act on the imperfection. But see U.S. Treas. Dept., Public Policy for American Capital Markets, BNA 1974 SEC. REG. L. REP. NO. 239, at D-1, D-12-14 (Feb. 13, 1974) (prepared by James H. Lorie).

¹⁴. Estimates for December 31, 1972, indicate that insurance companies, investment companies, noninsured pension funds, nonprofit institutions, common trust funds, and mutual savings banks hold 29.6 percent in value of all New York Stock Exchange listed stocks, up from 19.9 percent in 1962. This total would increase to about 45 percent when the holdings of bank administered personal trust funds, investment counseling firms, foreign institutions, nonregistered mutual funds, hedge funds, and nonbank trusts are included. N.Y. Stocx Exct., 1973 Fact Book 51 (1973). During 1971, institutions and intermediaries accounted for 69.7 percent in number of shares and 68.2 percent in dollar value of all public trading on the New York Stock Exchange, as compared to 33.3 percent and 38.7 percent respectively in 1961. Id. at 54.


¹⁶. See, e.g., CAL. INS. CODE §§ 1150-59 (West 1972); ILL. REV. STAT. ch. 73, §§ 737a-737.22a (1973); N.Y. INS. LAW §§ 78-79 (McKinney Supp. 1973-74) (legal investments include such traditional insurance investments as government obligations, certain secured corporate obligations, and certain mortgage loans as well as adequately secured noncorporate obligations, tangible personal property, certain common stock, and a “leeway” provision).

Federal statutes restrict the investment powers of commercial bank members of the Federal Reserve System and federally administered retirement funds. Traditionally, many of these legal lists have emphasized more conservative fixed income securities.

Such regulation may be justified in several ways. Of primary importance is the strong societal interest in minimizing the probability of bankruptcy and failure for those institutions which carry fixed contractual obligations to their beneficiaries. Were an insurance company or bank, for instance, to go bankrupt, society would lose an institution filling a vital need. This societal interest is, moreover, in accord with the ultimate interests of the underlying beneficiaries of such institutions. The interest of the bank depositor centers on the contractual fixed debt and income obligation of the bank; the interest of the insured policyholder centers primarily on the contractual insurance or annuity component and only secondarily on possible future policy dividends. Legal lists as a regulatory mechanism to monitor the investment policies of such institutional investors have consequently evolved in an effort to meet these objectives. Recently, many legal lists have been amended to permit the acquisition of certain common stocks which meet specified eligibility standards in terms of past dividends and earnings history and listing and registration requirements. The random walk hypothesis tells us, however,
that a security's past performance may not be a good guide to its future performance. To this extent, this form of investment regulation is "imprecisely related to its objective"\textsuperscript{24} of risk regulation.

The investment powers of a second group of investment intermediaries are governed by the prudent man rule.\textsuperscript{25} Generally, funds in trust for which the trust instrument is silent as to investment powers must be invested according to this judicially developed rule. Such trustee-managed investment portfolios would include, for example, funds placed in trust with banks and individuals, such as the assets of certain private noninsured pension funds and endowment funds. Under the prudent man rule, trustees are directed to purchase only those investment (as distinguished from speculative) securities which might be purchased by a prudent man in the permanent disposition of his funds.

The prudent man rule, however, does not necessarily serve the best interests of the trust beneficiaries.\textsuperscript{26} The focus of the rule has been to protect the trust corpus by limiting the risk of capital loss. It reflects "clearly and without question . . . the legally established concept of the trustee as conserver . . ., rather than creator, of capital."\textsuperscript{27} Underlying this concept is the hypothesis that prudent men often divide their careers into an active risk-taking phase, subsequently followed by a phase of consolidation and conservation. The trust may be viewed as a social institution tailored for the second conserving phase.\textsuperscript{28} The presumption is that silent settlors would wish the trust corpus to be invested as a prudent man would invest. To alter this presumption would be to destroy such expectations of past and present suits. Whenever a prudent man would not purchase an investment, the settlor would have presumed that a prudent man would not purchase it.

\textsuperscript{24} Note, supra note 15, at 611.
\textsuperscript{25} Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830). See Note, supra note 15, at 612-16.
\textsuperscript{26} Note, supra note 15, at 622-24.
\textsuperscript{27} Torrance, Legal Background, Trends, and Recent Developments in the Investment of Trust Funds, 17 LAW \\& CONTEM. PROT. 128, 134 (1952). See also Headley, Trustees as Conservators, TRUST BULL., Mar. 1950, at 15.
\textsuperscript{28} The prudent man regulation of trusteed investment portfolios may also reflect other factors. First, such regulation may be justified by a merit judgment of society against the notion of risk. Second, it may evidence society's desire to protect trusts from the irrational investment behavior of their trustees. Indeed, the original strict New York rule on trust investments was said to be "better adapted to inexperienced or ignorant trustees, as much is left to their discretion, and unfortunately trustees are too often appointed from considerations of friendship, and not from considerations of their discretion or business ability." Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 OHIO ST. L.J. 491, 496 (1951) (quoting A.P. Loring). See N.Y. PERS. PROP. LAW § 21 (1909). Insofar as most trusts are now managed by professional (corporate) trustees, the protective interest of the state may no longer justify the strict regulation of portfolio risk through the prudent man rule. Finally, although Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), played an important role in freeing savings for commercial use in the nineteenth century, Shattuck, supra, at 494, a state fiscal interest is of little justification to the broad regulation of trust portfolios.
present settlors that have been relied on. An equally attractive presumption, however, is that the silent settlor would wish the trust corpus to be invested in the best interests and according to the preferences of the trust beneficiaries.\textsuperscript{29} Although this standard might for many beneficiaries follow the conserving bias of the prudent man rule, it would place an affirmative obligation on the trustee to assess the actual preferences of the beneficiaries.

Investment companies are another group of savings intermediaries for which there may be a significant divergence between the preferences of the underlying investors—the fund shareholders—and those of the fund's money managers. The objective characteristics of an investment company's portfolio are determined at first on a unilateral basis by the company. Every registered mutual fund must file a statement with the Securities and Exchange Commission indicating the extent to which it will engage in certain investment activities, such as commodity and real estate investments, and describing the fund's expected percentages of industry concentration and issuer diversification, and portfolio turnover levels. Finally, the statement must set out other fundamental policies and investment policies changeable only by shareholder vote.\textsuperscript{30}

Fund shareholders with similar preference patterns are expected to select themselves by investing in the fund. By purchasing shares in a fund with reliance on these policy statements, the fund shareholders in effect contract for the type of investment portfolio described in such statements. Moreover, those investment policies which are labelled fundamental or otherwise set out as binding cannot be changed unless authorized by a majority of the fund's outstanding voting securities.\textsuperscript{31} However, because few funds wish to freeze their traditional risk levels by describing them as fundamental or otherwise binding in the absence of a stockholder's vote,\textsuperscript{32} the primary

\textsuperscript{29} The possibility of differing investment objectives between the life beneficiary and the remainderman is a continuing problem. However, this problem may be limited under a regime which directs the assessment of beneficiary investment preferences in the same way as it is limited under the prudent man rule. See Restatement (Second) of Trusts §§ 183, 252 (1959) ("a duty to the successive beneficiaries to act with due regard to their respective interests"); A. Scott, Law of Trusts §§ 183, 252 (1967). Cf. Note, Common Stocks in Trust, 113 U. Pa. L. Rev. 228, 250-59 (1964).


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investment objective of many mutual funds is left unrestricted. Consequently, the fund shareholder must rely on vague statements of crucial fund attitude towards portfolio risk and return—as, for example, the fund’s investment objectives are growth of capital and income, the objective is appreciation of capital for investors, or, simply, the primary emphasis is on income. In practice, therefore, the investment characteristics of a fund’s portfolio may well diverge by design or otherwise from what was expected by the fund’s shareholders.

Although Professor Malkiel believes that the random walk hypothesis establishes the unlikelihood of outperforming the market on a consistent basis, he does set out a theoretically sound (and empirically verified) way in which to beat the market over the long run. “One of the best-documented propositions in the field of investment is that on average investors receive higher rates of return for bearing greater risk.” Accordingly, an investment portfolio that carries greater risk than the market portfolio would be expected to outperform the market portfolio over the long run. Professor Malkiel gives us, furthermore, an effective proxy measure for investment risk, the beta coefficient. Although the beta estimates for individual securi-

Investment Co. Act Release No. 167 (July 23, 1941) (“It is clear that section 8(b)(2) [now substantially section 8(b)(3)] merely affords the registrant an opportunity, without in any way obliging it, to make statements of fundamental policy which will bind the company in the absence of a stockholder’s vote”).

35. The Wiesenberger study divides mutual funds into the following investment objective categories: capital gain, growth, growth-income, growth-income with relative stability, balanced, income, and other special investment vehicle funds. INVESTMENT COMPANIES 1973, at 45-49 (Wiesenberger Services, Inc. ed. 1973).

36. A fund can avoid violating the Investment Company Act of 1940 § 13(a), 15 U.S.C. § 80a-13(a) (1970), in the change, for example, from a growth and income investment orientation to a strictly growth orientation, by not stating such policy as fundamental or otherwise binding. Such a change, however, could lead to liability under the antifraud provisions of the securities acts or under common law fraud. Liability would certainly arise if the fund so misrepresented its investment orientation in its prospectus. But any divergence from such an investment orientation may be difficult to establish because of the vague nature of the investment goal. This would not be the case if a fund’s investment policy were set out in quantifiable risk measures.

36. Pp. 173-75. The beta coefficient is the regression coefficient in the linear equation: 
Rj = \alpha + \beta R_m + \epsilon_j, where Rj is the return to security j, Rm is the return to the market (as measured by some market index such as the Standard & Poor's 500 Corporate Stock Price Index), \alpha represents an individual security effect, and \epsilon_j a random component. In effect, beta measures the volatility of return of security j relative to the volatility of return to the market index. For example, a beta of 1.25 for a particular security or portfolio would indicate a 1.25 percent change in return for that security or portfolio for every 1.00 percent change in return for the market index. In statistical terms, beta is the covariance of the particular security and market index divided by the variance of the market index. See H. MARKOWITZ, supra note 4; W. SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS (1970); Tobin, supra note 4. See generally STUDIES IN THE THEORY OF CAPITA
ties are of questionable accuracy and stability over time, the beta coefficient for a portfolio of securities is a good measure of a portfolio's market sensitivity because of the diversification away of all unsystematic risk.\textsuperscript{37}

If it is thus possible to characterize and quantify the risk carried by a particular investment portfolio, then the beta coefficient may be used to judge the appropriateness of such a portfolio for a particular group of underlying investors. The ultimate beneficiaries of any investment portfolio certainly desire the maximum amount of return for the degree of risk carried. In theory, return as well as risk should be evaluated against an investor's preference for risk and return.\textsuperscript{38} In practice, however, the characterization of investors by desired risk levels makes good common sense and may even be considered feasible.\textsuperscript{39} For example, those individuals who invest in a growth mutual fund are certainly willing to bear more risk than those who invest in a balanced or income fund. The determination might be made that a balanced mutual fund should carry an investment portfolio with a beta of approximately 1.00, that is, a portfolio which moves 1.00 percent for every 1.00 percent move in the market. A growth fund perhaps should carry an investment portfolio with a beta substantially more than 1.00, say 1.50 or larger, and the portfolio of an income fund should have a beta of .75 or less. With such standards, fund shareholders could review and enforce that most essential dimension of a fund's investment policy, its attitude to portfolio risk and return.

expected rate of return at some future horizon date. Strictly speaking, this concept may be quantified by measuring the "width" of the probability distribution of future returns. However, because of the difficulty of assessing the distribution of future returns, a proxy measure based on the volatility of past returns is typically used.\textsuperscript{37} The risk associated with a security's future price movements can be broken down into two components, market and nonmarket influences. Most, if not all, securities respond to market movements which reflect aggregate growth or change in the economy tempered by the investor confidence level. In addition, particular securities respond to those forces which are peculiar to their own environment. Statistically, the variance of return of a particular security is the sum of a market or systematic risk element and a nonmarket or unsystematic risk element:

\[
\text{var} (R_j) = \beta_j^2 \text{var} (R_m) + \sigma_j^2
\]

In an efficiently diversified portfolio, the unsystematic risk elements of the individual securities cancel each other out leaving only the systematic risk. As a result, beta, or the volatility of the portfolio relative to that of the market, should be a good proxy measure of the risk carried by an efficiently diversified portfolio. An investment portfolio of from 15 to 20 securities will most likely be efficiently diversified. Blume, \textit{On the Assessment of Risk}, 26 J. FIN. 339 (1973). Moreover, the beta for such an efficiently diversified portfolio is likely to be stable over time, thus justifying the use of past historical data as the basis of a construct for a proxy measure of future risk. Levy, \textit{On the Long-Term Stationarity of Beta Coefficients}, 27 FIN. ANAL. J. 55 (1971).

\textsuperscript{38} See Note, supra note 15, at 616-24.

\textsuperscript{39} See Cohen, supra note 4, at 1623-25.
At present there is no real way to assess the consistency of a fund's actual investment policy with the risk parameters set forth in its prospectus and selling literature. Typically, an investment company will report to the fund shareholders its investment results in terms of portfolio return over the past ten years. However, examining portfolio return after the fact cannot by itself be used to determine the consistency of investment behavior with stated investment policy. Portfolio return must at the minimum be adjusted for portfolio risk. And the amount of risk carried by a fund's investment portfolio should be consistent with that set out as an investment objective.

Although the beta risk classification perhaps is applied more easily to investment companies, the investment portfolios of other institutional investors may be more directly tuned to the risk classification of their ultimate beneficiaries in a similar way. For example, those statutory eligibility standards for the admission of common stocks into insurance company portfolios could be directed more specifically to risk rather than to recent dividend history. This might be done by establishing a certain aggregate risk level, measured by the beta coefficient, for the aggregate common stock portion of such a portfolio. In addition, trusteeed investment portfolios might be reviewed with a similar focus on risk as measured by the beta coefficient, rather than by making some vague distinction between investment and speculation. Several institutions are, in fact, reported as "actually running funds by beta theory" and the Wells Fargo Bank's contract for management of the Samsonite Corp.'s Pension Fund is said to call for "maintenance of specific beta parameters."

Despite the rapid postwar growth of the institutional investors and the temporary disenchantment of many individuals with the stock market, individual investors still play a major role in the capital markets. However, Professor Malkiel's focus on giving advice to the individual investor is nonetheless in one other way misdirected. While the number is uncertain, many of these individual investors who

40. See note 36 infra.
43. Estimates for December 31, 1972, indicate that individuals hold directly about 55 percent in value of all New York Stock Exchange listed stocks. See note 14 supra. During 1971 individuals accounted for 40.3 percent in number of shares and 31.8 percent in dollar value of all public trading on the New York Stock Exchange. N.Y. STOCK EXCH., supra note 14, at 51, 54.
purchase directly in the markets do not do their own investment decisionmaking.

The securities industry has long been considered especially in need of regulation for the protection of investors. Ever since the enactment of the first federal securities law in 1933, primary regulatory reliance has been placed on a system of disclosure.\[^4\] Securities regulation for the protection of investors through disclosure requires the active participation of such investors. It is not enough for issuers of securities to "tell all" during their initial public offering and continuously thereafter if widely traded. The investor, presumably the investment decisionmaker, must after disclosure weigh the evidence and make the decision to buy, sell, or hold. In theory, disclosure is an efficient mechanism which protects investors while minimizing government interference with the capital markets. In practice, primary reliance on disclosure by the federal securities laws for the protection of certain classes of investors has not worked. Certainly, many studies have listed operational deficiencies in the disclosure mechanism and the remedial action required.\[^4\] For example, one problem for the individual investor is the comprehensibility of disclosure;\[^6\] also great-

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44. Disclosure as the primary mode of securities regulation has been justified as a deterrent to both fraudulent and nonfraudulent but wildly outlandish speculative schemes, see L. BRANDEIS, OTHER PEOPLE'S MONEY 92 (1914), as a way to place all investors on the same equal footing, SEC v. Texas Gulf Sulphur Co., 401 F.2d 839, 848 (2d Cir.), cert. denied, 394 U.S. 976 (1968), and as a means to enable investors to make their own informed investment decisions with minimal government interference, see H.R. REP. No. 1383, 73d Cong., 2d Sess. 2 (1934); SEC, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 10, 50-51 (1969) [hereinafter cited as WHEAT REPORT].


46. The danger of incomprehensible disclosure has been recognized by the Securities and Exchange Commission. SEC Securities Act Release No. 5119 (Dec. 16, 1970); WHEAT REPORT, supra note 44, at 77-88. Unfortunately, the interest of the registrant and his advisers has come to be at odds with the interests of all but professional investors in comprehensible disclosure. The registrant has an incentive to provide as complete a set of financial documents as possible in order to avoid the harsh liability provisions. However, as prospectuses and other filings become ever lengthier and more complex, the disclosures are of diminishing marginal utility to investors. In response to this dilemma, the Commission has encouraged registrants to "reduce the size of the prospectus by careful organization . . . , appropriate arrangement and subordination of information, use of tables and the avoidance of prolix or technical expression and unnecessary detail." SEC Securities Act Release No. 4936 at 6 (Dec. 9, 1968). See also SEC Securities Act Release No. 5278 (July 26, 1972). In addition, the Division of Corporation Finance has determined that an understandable and readable summary should be included in the forepart of any complex or lengthy prospectus and proxy statement. SEC Release No. 5119, supra. To provide a sanction, the SEC has stated that, unless a bona fide attempt has been made to produce a readable prospectus, requests for acceleration of the effective date may be denied. 17 C.F.R. § 230.460(f) (1973). Despite this effort, the SEC has recently concluded that "registrants continue to file prospectuses which are so complex or lengthy as to be of little use in informing investors other than those possessing exceptional analytical skill." SEC Release No. 5119, supra.
ly important to him is the accessibility of disclosure. There are, however, two questions about disclosure which cut through to the underlying assumptions and theoretical framework.

First: Are investors the actual decisionmakers? The efficient operation of the disclosure mechanism will not directly benefit the ultimate investor unless he himself makes his own investment decisions. The disclosure model is based on the assumption that the investor will actively participate in his own self-protection by making informed investment decisions. If this assumption is not met, the effectiveness of disclosure is limited to the professional investment decisionmaker, leaving a gap between him and the ultimate investor.

Whether an investor makes his own investment decisions is difficult to answer with any accuracy. One group of individual investors will place their investment portfolios with investment advisers and broker-dealers, granting them explicit or implied discretionary authority to make investment decisions. Because they do not do the investment decisionmaking, these individual investors cannot actively participate in their own self-protection in the securities markets. A second group of individual investors, while not giving discretionary authority to an investment adviser or broker-dealer, will rely almost exclusively on the investment recommendations of his investment adviser. Again the locus of investment decisionmaking is in the hands of investment adviser or broker-dealer.

That this is so is hardly surprising and, indeed, may have been anticipated by the architects of disclosure. Surely, the actual operation of the disclosure mechanism is better designed to provide relevant information to investment advisers and broker-dealers than to individual investors. While perhaps directly available to investment advisers

47. Once disclosed in an understandable format, relevant information must be made easily accessible to the investment decisionmaker. Information disclosed under the Securities Act of 1933 is presented in a prospectus and subject to delivery requirements. Unless the prospectus is in the hands of the investor before an investment decision is made, the disclosure mechanism will be of little help. In practice this means the preliminary prospectus is disseminated to investors as well as participating underwriters and dealers prior to the effective date of the registration statement. Despite SEC policy to delay this acceleration of the effective disclosure date until steps have been taken to secure adequate distribution of the preliminary prospectus, 17 C.F.R. §§ 230.460, 240.15c2-8 (1973), SEC Securities Act Release No. 4968 (April 24, 1969), wide variations have been reported in the availability of prospectuses. WHEAT REPORT, supra note 44, at 111-13. More difficult problems are to be found in increasing the dissemination of 1934 Act information on the statistically more important trading markets. The widespread use of a microfiche system should improve radically the accessibility of 1934 Act filings. WHEAT REPORT 313-23. But, in practice this may mean accessibility for professional money managers and broker-dealers.
and broker-dealers, the information disclosed by corporate registrants is accessible to many individual investors only through the filtration process,\textsuperscript{48} and then only after having been predigested into a comprehensible format. If reliance is placed on the filtration process for ensuring the accessibility and comprehensibility of disclosure for the individual investor, then it might also have been anticipated that reliance would be placed on the filtration process for investment decisionmaking.

Investment advisers and broker-dealers can be described as decision-making intermediaries for many individual investors. Not only does the disclosure mechanism work more efficiently for the professional investment decisionmakers,\textsuperscript{49} but also they hold themselves out as professionally qualified to make rational and informed investment decisions. Notwithstanding Professor Malkiel's opinion of their competence, investment advisers and broker-dealers represent themselves as able to select that investment portfolio best suited to the particular needs of their individual clients. Like many institutional investors, they frequently laud the ability of their research analysts and the financial expertise of their registered representatives or investment counselors. Individual investors attend to these claims, and thus the professional investment advisers secure themselves at the locus of decisionmaking for many individual investors. It follows that the effectiveness of disclosure stops with them instead of carrying over to the actual investor. Therefore, the federal securities laws cannot rely alone on the disclosure operation for the protection of such investors. Reliance must also be placed on some other mechanism to complete the connection from the investment adviser or broker-dealer who makes the decision and for whom disclosure is meaningful to the individual investor who puts up the money and for whom the decisionmaking is done.

The second crucial question about disclosure is: Do investors have

\textsuperscript{48} The SEC has relied on a filtration process for the effective operation of the disclosure mechanism. \textit{Wheat Report} 51-54. Information of a complex and technical nature disclosed in a prospectus or other filing is expected to filter down through the various investment intermediaries to the ultimate investor in a presumably more digestible form. This was, indeed, foreseen in an early critique: Even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in a registration statement, there will be those who can and will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market place. Through them investors who seek advice will be able to obtain it.

\textsuperscript{49} See \textit{SEC Special Study}, supra note 45, at 93-132.
the ability to make rational investment decisions? Basic to the theory of protecting investors through disclosure is the assumption that the individual can make informed, rational investment decisions on his own. The efficient disclosure of relevant information presented in a comprehensible format can be of no real use to investors not capable of acting on it to construct an appropriate portfolio. Certainly, whether because of a want of financial acumen, the lack of necessary time for analysis, or perhaps a weakness for speculative stock promotion, many investors are incapable of making rational investment decisions themselves. Of this group of investors, many will recognize their inability to make informed investment decisions and will leave such decisionmaking to the institutional investors, investment advisers, and broker-dealers. Others, whether aware or unaware of their shortfall in ability, nonetheless will continue to make their own investment decisions.

Of this second group of individual investors—those who directly make their own investment decisions—some will be qualified to make informed and rational investment decisions, both on an individual security and portfolio basis, if sufficient information is available to them. The concern of the federal securities laws with the protection of these investors should be directed to improving the operational efficiency of the disclosure mechanism. The balance of this group, however, will be made up of those individual investors who make their own investment decisions, although not qualified to do so. Their inability to make informed and rational investment decisions means that disclosure, even if operationally efficient, cannot ensure the protection of such investors.

Such investors must make up a not insignificant proportion of the total number of individuals who do their own decisionmaking. A 1961 survey by the Opinion Research Corporation indicated the possible breadth of individual investor inability to understand the type of financial information crucial to investment decisionmaking. Of the stockholders surveyed, 43 percent understood little or nothing from a company's formal financial statements, more than 50 percent could not define the meaning of depreciation, and virtually all were confused by the concept of cash flow.50 Even an understanding, however,

of the financial information necessary to gauge the fundamental value of a security will not ensure the construction of a suitable portfolio. Because prices of different securities may co-vary in different ways with one another, selecting an appropriate portfolio requires more than merely choosing individual securities which by themselves appear attractive. The ability to make informed and rational portfolio, as well as individual security, investment decisions may thus be more difficult to develop than anticipated.

To the extent that such individual investors lack this ability, the disclosure of relevant information on all publicly traded securities cannot help them select an appropriate portfolio. Of course, advocates of a strict disclosure theory of securities regulation believe that such investors should be free to make consistently foolish as well as wise investment decisions once all relevant facts have been disclosed.\(^5\) In other areas, however, federal regulation of the securities markets has gone beyond a strict adherence to the disclosure rationale.\(^6\) These investors would be better protected, if only from themselves, by some mechanism which would transfer the benefits of disclosure from the broker-dealer for whom disclosure is meaningful and who executes the orders to the investor who, however unwisely, makes his own investment decisions.

One possible way to assist both those investors who do not and those who cannot make their own rational investment decisions is to strengthen the existing obligation of broker-dealers to recommend only those securities which will make up a suitable investment portfolio for the particular investor.\(^5\) Historically, the suitability rules have been rarely used with the single objective of suitable investment portfolios strictly in mind. Rather, the focus of their use has been

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\(^5\) See also 17 C.F.R. § 240.15b10-3 (1973).
The Random Road to a New Suitability

in the proscription of broker-dealer fraud and in the exhortation of broker-dealers to maintain high ethical standards.\textsuperscript{64} With the recognition that the locus of effective investment decisionmaking for individual investors is often in the hands of the broker-dealer, the suitability rules, appropriately armed, may become the necessary supplement to disclosure.

For example, if one accepts the propositions that higher rates of return are earned over the long run on those portfolios bearing greater risk and that beta is a viable proxy measure for risk, then the beta coefficient may be a way to gauge the suitability of a portfolio for an individual investor. Accordingly, the suitability rules could impose an obligation on the investment adviser or broker-dealer to recommend or select only those securities which make up a portfolio with a beta coefficient suitable for the actual investor. To meet this obligation, the investment adviser first would have to identify the most appropriate risk level for the investor, given the investor's total financial situation and particular investment objectives.\textsuperscript{55} The investment adviser then would select for the investor's portfolio only those securities which generate such a risk level for those investors who do not do their own decisionmaking, and recommend only such securities for those investors who do their own decisionmaking, whether qualified or not.\textsuperscript{56} Indeed, if one accepts the strong form of the random walk hypothesis, and thereby assumes an efficient capital market, the risk decision is the only decision to make because of the absence of any undervalued securities on the market place. A further decision—which securities will yield the highest portfolio return for the amount


\textsuperscript{55} Although the NASD suitability rule was once construed to place an affirmative obligation on the broker-dealer to ascertain a customer's needs and resources, Gerald M. Greenberg, 40 S.E.C. at 137-38, the emphasis is now on the making of suitable recommendations on the basis of those facts, "if any," disclosed by the customer. Cf. SEC SPECIAL STUDY, supra note 48, at 311-12; Mundheim, \textit{Professional Responsibilities of Broker- Dealers: The Suitability Doctrine}, 1965 DURE L.J. 445, 458. But cf. NASD, TAX SHELTER PROGRAMS 56-57 (1972) (proposed suitability rules for tax sheltered investments). However, the SEC rule appears to place a duty on the broker-dealer to make an investigation. 17 C.F.R. § 240.15b10-5 (1973) ("on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs"). \textit{See also} 17 C.F.R. § 240.15b10-6 (1973) (SEC record keeping requirements); § 240.15c2-5 (1973) (affirmative suitability obligation in the equity funding area).

\textsuperscript{56} A broker-dealer should certainly be free to execute any order given to him by an investor who does his own investment decisionmaking and to answer specific inquiries when asked to do so by such an investor. However, the broker-dealer for such an investor should be under an obligation to recommend only those securities which meet the investor's suitability risk level and to categorize for the investor other securities as unsuitable. Mundheim, supra note 55, at 472-73.
of risk chosen—must be made if the random walk hypothesis is not accepted. The adoption of such an affirmative suitability standard would complete the connection between the investment adviser for whom disclosure is meaningful and the investor who does not or cannot make his own rational investment decisions. Assuming that disclosure is both comprehensible and accessible to the investment adviser, this standard would ensure that the benefits of such disclosure are transferred to the individual investor.

Aside from making the disclosure system more effective for the individual investor, the imposition of such a suitability obligation on the investment adviser or broker-dealer may be justified in other ways. Certainly, the investment adviser or broker-dealer occupies a fiduciary position when he has express discretionary authority to manage the investment portfolio of an individual investor. Because the investor depends, and desires to depend, on investment advice, a fiduciary obligation also exists when an adviser has only informal discretionary authority or when the investor habitually follows such investment advice. The individual investor, moreover, often is encouraged to rely on the self-asserted expertise of his investment adviser or broker-dealer. The investment community has over the years sought to create for itself an image of expertise and professionalism. The dependence of the investor and the alleged expertise of the investment adviser or broker-dealer combine to impose a fiduciary obligation on the adviser or broker-dealer which demands an affirmative duty stronger than mere disclosure.

Although the investment community characterizes itself as professional, the standards used to ensure the fulfillment of its fiduciary obligations perhaps should be more rigorous than the malpractice standard which governs the behavior of other professionals. Clearly, professionals such as doctors and attorneys must complete a more comprehensive education program and entrance examination than that required for registered representatives. A more important dif-

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57. See SEC SPECIAL STUDY, pt. 1, at 246-48, 323; Mundheim, supra note 55, at 446-47.
ference, however, lies in the manner of compensation. Insofar as registered representatives are compensated for merchandising securities, a conflict of interest exists which is not present in the relationship between a doctor and his patient or a lawyer and his client. To be sure, the desire to maintain a continuous relationship with the customer by dispensing profitable investment advice mitigates this conflict. However, the compensation for a sale is certain and immediate while compensation from future trading activity must be discounted as more remote. These differences suggest the imposition of a more objective and rigorous performance standard for the investment adviser or broker-dealer than the conventional malpractice type.

An affirmative suitability rule is a way to improve the protection of investors in our system of securities regulation. In some areas, investment advisers have taken up beta as an objective risk standard and a guide to suitability. In another area, tax shelter investments, the National Association of Securities Dealers has gone further by proposing absolute suitability rules. However, the revitalization of suitability should be viewed as only a supplement to, and not a substitute for, disclosure. When investors do not make their own investment decisions, the disclosure process is short circuited. And when investors who do their own decisionmaking are unable to make informed and rational investment decisions, the disclosure process does not serve its purpose. Unless there is some way to complete the connection from those for whom disclosure is meaningful to such investors, the federal securities laws will be unable to meet fully their ultimate objective of investor protection.

60. Although an investment adviser who receives a fee for his services may avoid this conflict, those advisers who are affiliated with a brokerage house may not be able to do so. Twenty-four percent of nonfund advisory complexes have affiliations with broker-dealers. SEC, supra note 15, at 361.


62. NASD, TAX SHELTER PROGRAMS §§ 5(b)(2), 5(b)(3), 56 (1972) (NASD sets standards of 50 percent marginal tax rate and $50,000 net worth).
Concerning Lawful Illegality*


Reviewed by M. B. E. Smith†

The Kadishs ask in their book whether one ever may lawfully break the law. Their startling answer is “Yes, and in a wide variety of circumstances.” The book is important, not merely because it propounds a bold answer to a question hitherto largely neglected, but also because it is chock-full of interesting arguments, presented in a persuasive style. Unfortunately, as is so often true of philosophical writing, what is interesting and important turns out to be flawed at its foundation.

I

The Kadishs focus primarily upon what they call “deviational discretion,” by which they mean a legally justified departure from mandatory rules. Mandatory rules are distinguished from other kinds of legal rules as being those that impose legal obligations; the authors’ usual test for discovering the mandatory rules of a particular legal system involves consideration of the legal obligations of those subject to it. “Rule” and “obligation” are of course not used here, as they often are in the literature of jurisprudence, in an “all or nothing” sense: When the authors say that a mandatory rule applies to a person and that he is obligated to follow it, they do not mean that departure from it is necessarily unlawful. Instead they introduce a sense of legal obligation that is meant to parallel W. D. Ross’s notion of a prima facie moral obligation. Their discussion of this notice is not entirely transparent, but I take it to be something like the following.

* In preparing this review I was greatly helped by discussion with Thomas R. Kearns, Assistant Professor of Philosophy at Amherst College.
† Associate Professor of Philosophy, Smith College.
1. M. KADISH & S. KADISH, DISCRETION TO DISOBEY 44 (1973) [hereinafter cited by page number only].
2. P. 2.
3. Ross’s notion of a prima facie moral obligation was introduced in W. Ross, THE RIGHT AND THE GOOD 16-64 (1930).
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Oftentimes we act within roles,\(^4\) which the Kadishs characterize as "established and continuing parts in a social enterprise or institution . . . [which] serve an accepted social purpose."\(^5\) Because of the role or roles we act within, we often have a "damn good reason"\(^6\) to do particular things. Such a reason has a "surcharge,"\(^7\) a greater weight than do reasons for acting which are not derived from acting within a role. These role reasons are not moral reasons, although a person may—and doubtless most often will—have a moral reason to act in accordance with them. Nevertheless, like moral reasons, they ordinarily carry the day when in conflict with other types of reasons; failure to act upon them is the kind of act that requires justification. Although the Kadishs do not explicitly make the equation, I take them to hold that legal obligations are nothing more than role reasons which stem from legally defined roles.

Using this conceptual apparatus, they explain justified departure from mandatory rules as being cases in which role reasons of different levels conflict. Roles have prescribed means and prescribed ends. The prescribed means are "more or less explicit limitations on what reasons will be considered acceptable for undertaking actions in a particular role";\(^8\) in a perfectly straightforward way these means impose role reasons upon those who act within particular roles. The prescribed ends of a role are the social purposes which are expected to be furthered by action in the role. Such ends are not usually specified by explicit rules and they are not usually relevant to a justification of action within the role. Nevertheless, the Kadishs argue, roles are sometimes structured so that a role agent may properly take his role's ends into account; and, when this is so, a consideration of what furthers a role's end may impose role reasons as genuine as those imposed by the role's prescribed means. For instance, a soldier may in a rare circumstance disregard the order of a superior and still act properly within the role of a soldier. Or, in order to alleviate great suffering, a physician may depart from the rule forbidding him to endanger the life of a patient. Roles which contain within themselves the possibility

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\(^{4}\) This paragraph is drawn primarily from the material at pp. 27-29. I must emphasize that I have ascribed to the authors a position they do not explicitly hold, \textit{viz.}, that role reasons are not moral reasons and, therefore, that legal obligations are not moral obligations. They strongly suggest this at p. 4 and pp. 211-16 and I think it reasonable to take them to hold it. I shall discuss below what consequences for their argument would ensue were they to identify legal obligations with a kind of moral obligation.

\(^{5}\) Pp. 15-16.

\(^{6}\) See p. 62.

\(^{7}\) P. 27.

\(^{8}\) P. 19.
for such deviation from prescribed means the authors call "recourse roles." 9

The Kadishs contend that recourse roles are ubiquitous in our legal system and in many other legal systems as well. Judges, policemen, juries, prosecutors, and even private citizens, in the course of acting within recourse roles, may lawfully disobey mandatory rules addressed to them. The authors' conclusion is, however, based upon a close examination of particular statutes and cases, not solely upon their conceptual machinery. They do not contend that deviational discretion must occur in every conceivable legal system. Rather, they say, it typically does, and thus analysis of a legal system must account for its possibility. The accounting may be made by distinguishing "principles of acceptance," which specify when departure from mandatory rules is justified, from other kinds of legal standards. 10

To a great many readers the foregoing may appear merely a description of elegant nonsense, for there is a strong tradition in jurisprudence that defines "rule" and "legal obligation" in such a way that a legally justified rule departure is logically impossible. 11 According to this tradition, a man's legal obligations are simply what the law requires him to do and a mandatory rule is simply one which must be obeyed on pain of acting illegally. A man may at times be morally justified in breaking the law, but to say that he could be legally justified is to misuse language.

The Kadishs call this traditional view the "producer's concept of obligation." 12 First, to reverse the order of their exposition, they attack it by suggesting that by its very nature obligation is "remittable." 13 Drawing a familiar example from moral philosophy, they point out that the obligation to keep a promise may in certain circumstances be outweighed by some more stringent moral obligation, but it does not on that account cease to be an obligation. Their argument appears to be that, since their notion of legal obligation is more intuitively plausible than that of the "producer's theory," the burden of proof rests upon proponents of the latter theory. Second, the Kadishs argue that their model of obligation better explains certain features of legal systems than does that of the producer's theory. Their

11. Recently, however, there seems to be a trend away from the "all or nothing" account of legal obligations and rules. See Murner, Validity and Legal Conflicts, 82 YALE L.J. 1140, 1150-56 (1973); Raz, Legal Principles and the Limits of Law, 81 YALE L.J. 823, 836 (1972); Note, Understanding the Model of Rules, 81 YALE L.J. 912, 919 (1972).
12. P. 194.
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argument for this proposition defies brief summary, but its general strategy can be clearly seen in their discussion of the obligations of the criminal jury.  

It is notorious that criminal juries in England and the United States have an absolute power of acquittal and that, in reaching this verdict, they may utterly disregard the law as it is explained to them by the judge. However, the law governing the proper behavior of the jury cannot be easily characterized, nor are the legal obligations of the jury clear. One traditional account is that the jury has an obligation to follow the judge's instructions on the law, but one that cannot be enforced. According to this view, juries that disregard the law simply act unlawfully; and, the only question to be asked about their conduct is whether they should be allowed to get away with it.

This characterization of the jury's obligation is not wholly satisfactory. First, it is plausible to suppose that legal rights and powers are correlative, that whatever a man is legally empowered to do he has a legal right to do. But the traditional view of the jury's obligation is inconsistent with this principle. Second, case law is not clear with respect to the jury's obligation to obey the judge's instructions. In criminal cases judges rarely attempt to bring pressure on the jury to find in accordance with the law; they do not require special verdicts on particular issues of fact, nor do they submit special interrogatories to the juries. Indeed, there is recent authority that such tactics are impermissible. If the jury really were obligated to find according to the law, one would expect to find such devices in common use. Third, judicial dicta generally agree that juries should have the power of nullification. As Learned Hand said, this "introduces a slack into the enforcement of law, tempering its rigor by the mollifying influence of current ethical conventions." Judges rarely defend unlawful activity with such eloquence.

Another traditional interpretation of the jury's role is that its obligation is merely to consult its conscience, but this view seems to fare little better than the first. As their behavior makes clear, jurors for the most part believe that they are obligated to obey the law; and it is hard to see why their power to act otherwise should show them to be wrong in so believing. Moreover, the jury is sworn to apply the law as it is given them by the judge; and one would think that their

16. United States ex rel. McCann v. Adams, 126 F.2d 774, 776 (2d Cir. 1942), quoted at p. 52.
Lastly, the jury may not be told that it can disregard the law in order to find for the defendant. Its discretion is, therefore, very different from ordinary delegated discretion, that exercised by an official who is given explicit instructions that within a certain range of alternatives he may follow his own best judgment in reaching a decision.

Finally, the Kadishs consider a third characterization of the jury's role and obligation: Jurors are bound to apply the law as it is explained to them by the judge, unless they believe its application will result in serious injustice. However, their argument against this view is unclear; and what part of it I think I understand seems plainly question-begging. The conditional view implies that, when the jury believes following the law will result in injustice, it is under no obligation to follow it. But I take the Kadishs to reject this implication: In such a case jurors are yet bound to give weight to the law; and so, their belief that following the law will result in injustice is a reason that overrides, rather than erases, their ordinary obligation. But this criticism seems to suppose that the jury's obligation is a "remittable" one; and, it is of course precisely this that is at issue.

Nevertheless, we can supply the Kadishs with an argument against the conditional view which in part parallels their argument against the second traditional solution. First, the juror's oath is categorical, not conditional; and so, to the extent that the oath determines the jury's obligation, the latter must be categorical as well. Second, jurors are not told, nor does the law allow them to be told, that their obligation is conditional. Finally, the conditional view has no particular intrinsic plausibility; its only attraction is that it allows us to avoid admitting that legal obligations can ever conflict. Hence, in default of an argument showing that conflict in legal obligations is impossible, it seems best to reject it in favor of any view that has plausible support.

The authors' solution to the problem is, of course, to hold that the jury's is a recourse role. At times its prescribed means (the rule bidding it to apply the law to the facts of a case) may conflict with its prescribed end (to secure justice), and in such a situation, a jury may lawfully depart from the prescribed means. The juror's oath, the judge's instructions, and the numerous dicta holding that the jury is obligated to follow the law are sufficient evidence that they are so

18. Their arguments against the conditional view begin at p. 62. They offer two arguments; but since I do not understand the second I make no effort to reproduce it.

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obligated and, hence, that there is a legal rule in force which requires them to decide in this manner. Still, the rule is not absolute, and they may depart from it by exercise of deviational discretion. But not every departure from the rule is lawful: A juror who votes to acquit because he has been bribed or threatened has disregarded overriding role reasons and so has acted without legal justification. The authors' theory thus allows them to explain the intuitively plausible proposition that jury nullification is legally justified when based on grounds of conscience, but otherwise is not.

II

I think the authors' conclusions are nearly irresistible if one grants their premises that there is such a thing as a legal obligation (analogous to a moral obligation but distinct from it) and that mandatory legal rules can be discovered by prior determination of legal obligations. Effective criticism of their views I think must be directed against these premises.

The notion of legal obligation distinct from moral obligation seems to be of recent origin. Certainly it was unknown to natural law theorists who dominated jurisprudence until the 19th century. They believed positive law drew its obligatory or binding force from its fidelity to the natural law or eternal moral order. The obligation to obey positive law, therefore, is simply a species of moral obligation.

So far as I am aware, the notion received its first full dress presentation in Austin's The Province of Jurisprudence Determined. Austin there advanced a will theory of obligation: A person is obligated to do a thing if, and only if, he has been ordered to do it by some superior and if he has a reasonable fear of suffering sanctions upon noncompliance. This theory was shopworn by Austin's time; it had been incorporated earlier in divine will theories of morality, and had been decisively refuted by Cudworth in the 17th century and Price in the 18th. Nevertheless, Austin used it to distinguish legal from moral obligations by noting that, whereas the former ones were established by the command of political superiors, the latter arise from

20. P. 68.
22. The relevant parts of Cudworth's and Price's work have been collected in 2 BRITISH MORALISTS 130-33, 155-67, 247-57 (Selby-Bigge ed. 1964); Cudworth's and Price's criticisms in large part anticipated Hart's criticisms of Austin's theory of obligation in H.L.A. HART, THE CONCEPT OF LAW 79-88 (1961).
the commands of men who enjoy no political superiority over those commanded.23

Although Austin’s work had unparalleled influence upon subsequent Anglo-American jurisprudence, most in this tradition have abandoned his theory of obligation.24 Nevertheless, virtually all have retained his distinction. Most who have delved into the subject, however, simply have assumed that legal obligations exist and then have attempted to explain their nature. Dworkin’s seminal article, “The Model of Rules,” is a good case in point, for while he begins by suggesting that serious consideration ought to be given to abandoning the mysterious notion of legal obligation, he soon dismisses his suggestion as “mostly bluff.”25

The Kadishs also accept Austin’s distinction. Although the threat of sanctions helps explain why people generally obey the law, they argue, it cannot explain completely this phenomenon. People often do obey the law when they need not fear sanctions, and even when they need fear them they often obey for other reasons. Moreover, people feel a need to justify their actions before the law. In short, the Kadishs appear to argue, because people believe themselves obligated to obey the law, legal obligations must exist.26

Even if one grants, however, that a generally held belief that a certain kind of action is obligatory is good reason for thinking it is obligatory, the authors’ argument is still not convincing. The key question is not whether there is an obligation of some sort to obey the law, but whether there is an obligation of a particular sort: one that is neither identical with nor reducible to a moral obligation. Doubtless most people think obedience to the law is generally obligatory. But the Kadishs’s implicit principle for discovering obligations is relevant to the question posed here only if people believe obedience to the law to be obligatory independently of any felt moral obligation to obey. And it seems doubtful that this is true. The plain man is not tutored in moral or legal philosophy; and, although he doubtless believes he has some obligation with regard to the law, he has probably not settled in his mind its exact nature and scope. Finally, although the plain man may believe that the ob-

ligation to obey occasionally conflicts with other moral obligations, one cannot conclude that the plain man therefore believes there are legal obligations which are not moral ones. It is likely that, when the plain man thinks the obligation to obey conflicts with some other obligation, he has in mind merely a conflict of moral obligations—after all, as the Kadishs themselves point out, something like Ross's notion of a prima facie moral obligation is implicit in ordinary speech.

Another argument for the concept of legal obligation has been offered by Dworkin: We cannot give up the idea because it is "too deeply cemented into the structure of our political practices." Unfortunately, he does not explain the exact process by which this masonry was accomplished, nor where in the edifice the concept can be found. But, his point, I take it, is that the language of obligation and duty is ubiquitous in legal writing; and we cannot suppose that the legal scholars and jurists who have used this language are all guilty of conceptual error.

It is not entirely clear, however, that when lawyers use the phrase "legal obligation" they mean to refer to any genuine obligation; they may perhaps use it simply to refer to what the law requires. But we may let this point pass, for there is a more damaging criticism still. So long as one holds that there is for the most part a moral obligation to obey the law one may doubt the existence of a separate legal obligation and still speak appropriately of duty and obligation to follow the law. It is most unlikely that when jurists and legal scholars use the phrase "legal obligation" they intend to refer narrowly to a kind of obligation other than moral. Lawyers, after all, are highly impressed by the moral authority of law; many, for instance, have asserted that there can never be a moral justification for civil disobedience. I think this a muddle-headed view, but that it is commonly held suggests that when lawyers use the phrase "legal obligation" they probably refer to obligations that are moral, if indeed they intend to refer to obligations at all.

In *The Concept of Law*, H. L. A. Hart made the most noteworthy recent attempt to distinguish legal and moral obligations. According to Hart, obligations are established by those rules that a society regards as very important. Not all social rules serve this purpose.

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28. It is reasonable to maintain that there is in no society even a prima facie obligation to obey the law. See Smith, *Is There a Prima Facie Obligation to Obey the Law?*, 82 Yale L.J. 950 (1973).
Rules of etiquette, for example, are not taken sufficiently seriously that it is appropriate to speak of their breach as failure to meet an obligation. Social rules impose obligations only when they satisfy three conditions. First, “the general demand for conformity . . . [must be] insistent and the social pressure brought to bear upon those who deviate . . . great.” Second, they must be thought important “because they are believed to be necessary to the maintenance of social life or some highly prized feature of it.” Third, rules impose obligations when “it is generally recognized that the conduct required by these rules may, while benefiting others, conflict with what the person who owes the duty may wish to do.”

Legal and moral rules have all of these features, but yet are distinct kinds of rules. Thus, the existence of distinctly legal obligations is guaranteed by the distinction between legal and other kinds of social rules. According to Hart’s theory, that a society regards a social rule as obligatory is not merely evidence that it is obligatory; it is sufficient to establish this. This strikes me as a bad theory of obligation. It implies, for example, that in Nazi Germany Aryans were under an obligation to shun the company of Jews: I take it that this is plainly false.

Fortunately, however, I need not criticize Hart’s general theory of obligation. Even if this is correct, and even if legal and moral rules can be distinguished clearly, one need not conclude that legal obligation is separate from moral obligation, because Hart has not excluded the possibility that legal rules give rise, not to separate legal obligations, but rather to moral ones. And it is striking that in the section of his book entitled “Moral and Legal Obligation” he does not even address this question, his principal concern there being to show that moral rules have characteristics that make them distinct from legal ones. But it is patently fallacious to conclude that, because a viable distinction can be made between legal and moral rules, the obligations imposed by the former cannot be moral obligations: One might as well argue that because families have rules that are

30. Id. at 84-85.
31. For criticism of Hart’s theory with which I am in general agreement, see Baier, Moral Obligation, 3 AM. PHIL. Q. 210, 215-17 (1966); Dworkin, Social Rules and Legal Theory, supra note 25, at 861-74. Baier there adopts a view of legal obligation similar to mine, viz., that laws oblige only by means of some moral obligation.
32. See H.L.A. Hart, supra note 22, at 163-76. He touches on the distinction between moral and legal obligation, id. at 199, and maintains that those who “accept the authority of a legal system” and who therefore are prepared to speak of persons having obligations under it are yet “not thereby committed to a moral judgment that it is morally right to do what the law requires.” It is disappointing that he merely asserts this and does not explain how, given his theory of obligation, such a person can avoid being so committed.
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not moral ones, and because family members are often obligated to follow these, there is yet another kind of obligation distinct from moral obligation, that is, family obligation.

Moreover, when by Hart’s account a social rule imposes an obligation, most probably it will be backed by a moral rule as well. Certainly the conventional morality of a society will condemn the breach of rules that are “believed to be necessary to the maintenance of social life or some highly prized feature of it.” Hart’s theory of obligation therefore seems to imply that any social rule that imposes obligations of any sort must impose moral obligations as well. This alone is fatal to the distinction between legal and moral obligation, since the only clear demonstration of the reality of this distinction would be a showing that laws can obligate independently of any moral obligation. Now, it may be supposed that what Hart means is that the obligation imposed by legal rules is explained not by the seriousness with which each rule is regarded, but rather by the seriousness with which the law itself, the entire body of rules, is regarded. Unfortunately, this emendation does not solve the problem. If a society thinks its legal system taken as a whole is necessary to its survival, preservation of the system will plainly be an object of its moral concern; and so it will be bound to have some moral rule or rules requiring obedience to the law. And, if by some unexplained process the seriousness with which the system as a whole is regarded is transferred to those mandatory rules that are not in themselves thought important, and if this seriousness is sufficient to ensure that they impose obligations of some sort, then by an analogous process the moral seriousness with which the system of rules as a whole is regarded likely will be transferred to the particular rules and ensure that breach of every mandatory rule will be breach of some moral obligation. Therefore, even if the emended version of Hart’s theory be granted, we still have no reason to believe that laws obligate independently of moral obligation.

Neither the Kadishs, Dworkin, nor Hart have given good reason

33. Hart must look to the entire body of the law, of course, simply because many mandatory legal rules are not regarded seriously. He takes implicit notice of this fact and maintains that a law may be valid even though it is not usually obeyed. Id. at 100. Although he does not say it explicitly, I take him to mean that such a law nonetheless might impose obligations. A law not generally obeyed is, of course, not generally thought momentous.

34. Someone may here be tempted to protest that I have not proven that Hart’s theory implies that whenever laws obligate in any way they impose moral obligations; at most I have shown that this may be so. But Hart, after all, undertook to show that legal obligation is distinct from moral obligation; and so it is no defense of him merely to maintain that, for all I have shown, they may be distinct.
to think that peculiarly legal obligations exist. I cannot demonstrate this here, but I think it fair to say that no other philosopher has done any better. We ought therefore to abandon the notion: According to Occam's razor, we ought not multiply entities beyond necessity; and it is plain that we ought to adopt a similar principle when considering whether to admit diverse kinds of obligation. Apart from considerations of simplicity, however, there is another argument that should make us suspicious of the usual notion of legal obligation.

Normative language is rife in our ordinary linguistic practice: Consider, for example, such diverse locutions as "This bolt is the wrong size" and "You were wrong to break your promise," or "You ought not eat your meat with the salad fork" and "Young men must still register for the draft." Obviously, not all of these sentences make moral claims, nor even claims about obligations. What is not obvious is how we know that this is so.

Many philosophers, following Kant, have attempted to distinguish moral judgments from other judgments couched in normative language on the ground that the former are categorical imperatives, whereas the latter are merely hypothetical imperatives. According to the Kantian view, all moral judgments give reason for acting. Hypothetical imperatives, however, give reason for acting only against a background of some agent's desires or interests, whereas categorical imperatives give reason regardless of what desires or interests the agent has. For example, if I want to go to New York as soon as possible and if the best way to do this is to leave immediately for the bus station, then someone might appropriately say, "You ought to go to the bus station immediately." However, the grammar of this sentence is deceptive, for in so saying he does not mean that I ought *simpliciter* to go to the station, but rather that I ought to do so on condition that I have a certain desire. Should I not have this desire, and so have no reason to go to the station, it would then be false to say that I ought to go to the station. Since the judgment applies to me only if I have a certain desire, it then seems appropriate to follow Kant in calling it hypothetical imperative.

In contrast, moral judgments—or so it is commonly supposed—are rather categorical in nature. When we say a man ought to treat his children kindly, we do not suppose that this is true on condition that he has a certain purpose or desire that will thereby be furthered. Moral reasons therefore apply to us independently of our particular

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desires and interests. Of course, one's desires and interests are not always morally irrelevant; such considerations may occasionally either qualify or outweigh a prima facie obligation of merely moderate stringency. No one, for example, holds that a man must bring ruin upon himself in order to fulfill a casual promise. But the moral weight of a man's particular desires and interests is a matter to be taken into account when calculating what he is morally bound to do, not something that can falsify any assessment of his obligations. We think that a man has a reason to do what is right, that he ought to do it, even though he may have no interest in so doing.

It is noteworthy that the language of obligation and duty is inapposite with respect to reasons established by paradigmatic hypothetical imperatives: One may properly say that I ought to go to the station, but it is simply wrong to say that I am under some obligation to do so. It seems reasonable to conclude, therefore, that a man's obligations are determined by the categorical imperatives that are addressed to him. Hence, if we are to take the notion of legal obligation seriously we must suppose that legal rules establish imperatives that are categorical but are not moral. What is more, those who have taken the notion seriously would not be prepared to admit that legal rules establish only hypothetical imperatives. For, as we have seen, an important motivation for admitting the existence of legal obligation is the recognition that the so-called "binding force" of law cannot be explained merely by threat of sanctions, that laws often obligate even when people need not fear sanctions and when obedience will frustrate their desires. But, if legal obligations were merely hypothetical imperatives, legal rules would have no "binding force" over the conduct of those who have no desire to obey the law and whose interests will not thereby be served: Such a person will have no reason—except perhaps a moral one—to obey.

Nevertheless, I suggest, it is most implausible to suppose that legal rules establish nonmoral categorical imperatives. Surely, no one except a person who makes an utter fetish of rules could suppose that the mere fact that a legal rule requires a man to do a thing is in itself a reason for him to do it, without regard to the moral character of the regime that propounded it and of the behavior which it requires, and despite the fact that following it may serve none of his purposes. For example, no one would seriously maintain that German citizens had a reason to follow the Nuremberg laws, when obedience would not suit their desires nor serve their interests. Hence, if we think that there is a distinction to be made between hypothetical and cate-
gorical imperatives, and if we agree that obligations are established by categorical imperatives, we must then admit that the obligation imposed by laws is a form of moral obligation, not something to be distinguished from it.

This conclusion, admittedly, can be evaded by rejecting the distinction between categorical and hypothetical imperatives. The evasion, however, can be accomplished only at great expense. For if we deny that any normative judgment is categorical, we must hold that they are all hypothetical, including those established by legal rules. If this is true, it follows that whenever obedience to the law does not suit our desires or further our interests it is false to say we ought to obey. This hardly seems an acceptable conclusion.

III

The foregoing argument, I believe, renders the authors’ method for discovering legal rules unserviceable, and so robs their claims about deviational discretion of necessary support. There are two lines of defense, however, which must be overcome. First, it may be suggested that “legal obligation” as ordinarily used in legal writing does not refer to a genuine obligation. Instead it is merely a grandiose way of referring to that which the law holds must be done. If this is so, one may properly determine what rules govern, for example, jury behavior by asking what are the jury’s legal obligations. The jury’s obligations are simply that which the law holds it must do; once the relevant law is unearthed the mandatory rules governing jury behavior become clear. In short, by adopting a nonnormative account of legal obligation, the authors’ method for discovering mandatory legal rules can be salvaged.

The Kadishs, however, could not accept this defense. The notion of what the law holds must be done is an “all or nothing one.” If they then held that the notion of legal obligation is equivalent to it, they would be committed to the so-called “producer’s theory of obligation,” and thus would have to abandon their claims about deviational discretion. Moreover, any analysis of legal obligation in terms of nonnormative propositions about what the law commands or requires poses the same problem. To use such analyses to discover legal

36. Philippa Foot has recently argued that there are no categorical imperatives. See Foot, Morality as a System of Hypothetical Imperatives, 81 PHIL. REV. 305 (1972). Her argument consists of hard questions about the Kantian distinction. However, although her questions are indeed knotty, I do not think them adequate reasons to abandon the distinction.
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obligations and legal rules, one must have some way of telling what the law commands; and it would seem that the only possible criterion is what law is prepared to enforce by threat of sanctions. But, this criterion too is an "all or nothing" one. The law either forces us to do a thing or it does not; it does not direct us by its sanctions in different directions, leaving us to choose the better path. To sustain their claims about deviational discretion, the Kadishs do indeed need a genuine notion of obligation, one analogous to that of prima facie moral obligation. One merely pretending to be normative will not suit their purposes.

Second, it may be thought that the authors' argument requires only that mandatory legal rules impose obligations and that such rules can be discovered by the obligations they impose, but that the obligation need not be distinct from a moral one. Moreover, as remarked above, the Kadishs may not believe moral and legal obligations are distinct. Perhaps they need only clarify or modify their description of the obligation imposed by mandatory rules, and the rest of their argument can remain undisturbed.

Unfortunately, matters are not so simple. If the Kadishs held that mandatory legal rules can be picked out by the moral obligations imposed by these rules, they would commit themselves to a version of natural law theory. Then they would meet the objection lodged against all such theories, that legal rules are to be discovered independently of their moral properties. To be sure, the Kadishs need not subscribe to the paradoxical shibboleth of natural law theory, "an iniquitous law is no law." Since they view obligation as "remittable," they could hold that even the worst mandatory rules of the wicked legal systems impose prima facie moral obligations and thus count as law.

Although a great many philosophers maintain that in a reasonably just state there is a prima facie moral obligation to obey all law, relatively few assert that the laws of every state impose such an obligation. But if there are legal systems so monstrous that those subject to them have no prima facie obligation to obey their laws, then there must exist mandatory legal rules which impose no obligations. Consequently the method of picking out legal rules by their obligations cannot be completely successful. In fact this ploy may never be successful. I have argued elsewhere that, although those subject to any legal system have at least a prima facie obligation to obey laws that

37. See note 4 supra.
prohibit acts *mala in se* and to obey those laws disobedience of which has untoward consequences, there is no legal system in which subjects have a prima facie obligation to obey the law in all circumstances. For example, I believe running a stop sign on a clear day with no one in sight violates no prima facie obligation. Nonetheless, there is a mandatory rule prohibiting this act, and the driver may be prosecuted if apprehended. There are, I believe, many mandatory rules in every legal system that, at least in certain circumstances, impose no obligation. From this fact one must conclude that the mandatory rules of every legal system must be discovered without reference to what moral obligation, if any, they impose.

Moreover, regardless of whether there is a prima facie obligation to obey the law, it is still a mistake to attempt to discover legal rules by the moral obligations they impose. The method implies that, because we know certain acts are immoral, we know they are illegal. But when an act is both illegal and immoral, and when the two qualities are connected by more than mere concomitance, the immorality of the act must be explained at least in part in terms of its illegality, rather than vice versa. If this is so, then to the extent that the immorality of an act is explained by its illegality, we must know that it is illegal before we can know it to be immoral.

For example, even though the jury has the power to disregard the law, its oath perhaps morally obligates it not to do so. Whether the oath so binds the jury, however, depends upon what significance is given the oath: It may be something the jurors are expected to treat seriously or it may be merely a formula recited by rote. The answer turns on whether failure to fulfill the oath counts, at least for the most part, as an unlawful abuse of authority. Thus one must know what mandatory rules apply to the jury before one can fix the nature and scope of its moral obligation. So again, the existence of particular mandatory rules must be determined independently of the moral obligations they impose.

The Kadishs propose to show that departure from mandatory legal rules is at times lawful. To pick out which rules may on occasion be justifiably departed from, they look to the legal obligations such


39. This qualification is dictated by my particular scruples; my view is that very often concomitance is the only relation between the illegality and the immorality of an act. I should hold this so in the case of rape, for I think its illegality in no way contributes to its immorality. In other cases, for example, running stop signs so as to endanger others, I think the immorality of an act is at least partly explained by its illegality. Nevertheless, my present point, that immorality cannot explain illegality, in no way depends upon acceptance of my scruples.
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rules impose. The method cannot succeed, however, because they cannot define the notion of legal obligation so that it will meet their ends: They require that it refer to genuine obligations, but moral ones will not do; as we have seen, laws do not obligate apart from imposing moral obligations.

The authors' claim that deviational discretion exists in virtually all legal systems is an exciting hypothesis and demands further exploration. It seems at first a paradoxical, almost nonsensical view, but upon reflection it receives some support from our intuitions. I believe it very plausible to maintain, for example, that there is a legal rule requiring the jury to find in accordance with the law, but that on occasion this rule may be departed from lawfully. Unfortunately, I believe that the hypothesis is supported now only by intuition. The authors' argument is consistently interesting and often ingenious; but I think it is badly flawed at its foundation, and I do not see how it can be put right.
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The Editors of the Yale Law Journal dedicate this issue to a departing friend, Professor Louis H. Pollak, who moves to Philadelphia this summer to become Albert M. Greenfield Professor of Human Relations and Law at the University of Pennsylvania.

Foreword

Eugene V. Rostow†

Professor Louis H. Pollak leaves Yale, after nineteen years on our faculty, with an altogether special aura. He is, of course, a penetrating scholar, whose articles, briefs, and oral arguments before the courts are a creative and respected part of modern constitutional law—as important, and as influential, as many of the judicial opinions he has examined with such scrupulous fidelity to his mature vision of our constitutional order. As dean in a troubled time, he served the cause of the university well, by demonstrating that passionate adherence to the principles of academic freedom and responsibility need not qualify a genuine sympathy for the feeling behind the follies of the day.

Mr. Pollak's special aura, however, reflects another aspect of his being. As scholar, teacher, and dean, he will always be a vivid thread in the tapestry of our history. But as a human spirit of singular purity, he will remain among our lares and penates. In a period which put character to the test, he dealt with students and colleagues as he dealt with the work of the Supreme Court—with patience, with tolerance, and with discrimination. In the end, however, he treated people as he treated ideas—with an undeviating and overriding concern for what he deemed right. In his life among us, he has always been a man of utter rectitude—not rigid or forbidding, as many men of rectitude are, but invariably perceived as one who was warm without being sentimental, and fair without being cruel: a just man, in short, and a man of justice.

This is not, happily, the occasion for a valedictory review of Mr. Pollak's career. He is young, after all, and in midstream. We should note, however, that his extra-university activities in New Haven, and in the national struggle for civil rights, have been field research for

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his scholarship. All his work, in the law reviews and in the forum, is of a piece. It is always the work of a disciplined scholar, who approaches every issue in the perspective of our constitutional problem. For him, each conflict, each effort to reconcile competing claims, must be resolved in accordance with the principled ideas of a constitutional system whose fulfillment and improvement are necessarily the first and highest goal of the social process in the United States. In Mr. Pollak's moral universe, no problem is rightly settled unless it is settled in a constitutional way. For him, deviation from this rule is the impermissible sin.

Lou Pollak has the gift of friendship. The lives of many students, and of all his colleagues, have been enlarged by the generosity and imagination of his concern for them. No differences about issues, however important, muted the chords of affection and respect which make his relations with friends so genuine, so resonant, and so rich.

We wish him well at our sister school in the University of Pennsylvania. But we say goodbye with pain.