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COMMENTS

EXPANDING ANTIFRAUD PROTECTION: THE PLEDGE OF STOCK UNDER SECTIONS 17(a) & 10(b) OF THE SECURITIES ACTS

INTRODUCTION

It is an acceptable, if not absolutely necessary, commercial banking practice to require a borrower to put up collateral as security for a loan.¹ To meet this requirement, a borrower will commonly place corporate "securities"² with the lending institution in order to satisfy the collateral obligation.³ This transaction is referred to as a pledge of stock.

A pledge of stock, or other property, transfers possession of the property to the "secured" pledgee. Legal title to the property remains with the pledgor, yet an inchoate property interest

1. From a lender's standpoint, an ideal risk situation would be to have all loans fully collateralized. Yet, obtaining an optimum return on its loans is often in conflict with this "ideal situation"; a bank will sometimes make unsecured loans to its "best customers" at higher interest rates. Thus, a bank must continuously reexamine the amount of secured and unsecured debt in its portfolio in order to achieve an optimum return while minimizing risk.

2. The term "security" is defined as:

Any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral right, or, in general, any interest . . . or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. Securities Act of 1933, 15 U.S.C. § 77(b)(1) (1976). This definition has been adopted verbatim in the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a) (36) (1976), and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a) (18) (1976). The definition of "security" in the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1976) is regarded as virtually the same as that in the 1933 Act. See *Tcherepnin v. Knight*, 389 U.S. 332, 335-36, 342 (1967). For a side-by-side comparison of the two securities acts' definitions of "security," see Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 221-22 n.13 (1974) [hereinafter cited as Hannan & Thomas]. The Supreme Court has specifically rejected technical distinctions between the Acts. See *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

3. See 1B A. BENDERS, U.C.C. SERV. § 14.01[1] at 1502 (1978); see also Hueter, *The Plight of the Pledgee Under Rule 144*, 91 BANKING L.J. 511 (1974).

inures to the pledgee. When the loan obligation is satisfied, the pledgee relinquishes his security interest to the pledgor.⁴ In the event of default, however, the inchoate security interest matures and the pledgee can foreclose on the collateral in satisfaction of the pledgor's debt obligation.⁵ The only restriction on the foreclosing pledgee in liquidating the collateral is commercial reasonableness.⁶

The rights of parties in a sale of stock are distinct from the rights of parties in a pledge situation.⁷ An ordinary seller of stock releases all rights in the stock upon consummation of the sale. A pledgor of stock, on the other hand, retains the right to sell the stock subject to the security interest, the right to vote the stock, and the right to receive dividends. The pledgor is also liable for any taxes applicable to the stock.⁸ A pledgor, then, does not release any of these incidental rights of ownership pursuant to the pledge transaction. It is only when the pledgee moves to foreclose on the pledged stock that the rights of the pledgor are terminated and, even then, the pledgee must ac-

4. See generally L. LARKIN & H. BERGER, A GUIDE TO SECURED TRANSACTIONS 6 (1970).

Pledges and other secured transactions are governed by U.C.C. article 9. Under that article, the pledgee must use reasonable care in the custody and preservation of collateral in his possession. Further, a pledgee is liable for any loss resulting from his lack of care, but in any event the pledgor does not forfeit his security interest. U.C.C. § 9-207 (1978). It is generally recognized that the pledgee is a fiduciary of the pledgor. See RESTATEMENT OF THE LAW OF SECURITY, §§ 17, 22 (1941) [hereinafter cited as RESTATEMENT OF SECURITY].

5. See U.C.C. §§ 9-502—9-504 (1978). In addition to foreclosure under the U.C.C., the secured party can usually avail himself of specific state laws governing creditor's rights. The pledgee may also choose to sue as an unsecured creditor in hopes of obtaining a judgment lien against the pledgor. Default can occur not only with nonpayment, but also when the pledgor, pursuant to a security agreement, refuses to provide additional collateral. See U.C.C. § 1-208 (1978).

6. U.C.C. § 9-504 (1978). See also U.C.C. § 9-507(2) (applicable tests as to what is "commercially reasonable").

7. In addition to the parties' rights, the motivations of the parties in a sale or pledge are also distinguishable. A seller is motivated by the direct receipt of consideration, whereas a pledgee's primary motive in accepting stock as collateral for a loan is to indirectly compel repayment by the threat of foreclosure. A pledgee-lender does not ordinarily intend to invest in the securities directly as a buyer would. See Comment, *The Pledge and the Purchase and Sale Requirement of Section 10(b) and Rule 10b-5*, 65 GEO. L.J. 1593, 1607 n.86 (1977).

The pledgee does, however, have a continuing concern that the rate of return and market value will be adequate in the event of default. It is this contingent and continuing concern that distinguishes pledges from bailments of securities. *Id.*

8. See L. JONES, COLLATERAL SECURITY AND PLEDGES, §§ 1, 176A, 441, 602 (3d ed. 1912).

count to the pledgor for excess proceeds received in a foreclosure sale.⁹

When fraud occurs in connection with a pledge of stock, it is usually the pledgee that is victimized and must seek relief.¹⁰ For example, a typical fraudulent pledge arises when the pledgor intentionally overstates the value of pledged securities in hopes of obtaining a larger and, in effect, uncollateralized loan. Upon discovery of the misrepresentation, the defrauded pledgee can seek a remedy in the state courts for common law fraud or corporate mismanagement. The aggrieved pledgee can also sue in a private action under the antifraud provisions¹¹ of the federal

9. See RESTATEMENT OF SECURITY, *supra* note 4, at § 27.

10. It is difficult to envision a situation where a fraud is perpetrated against a pledgor. Suppose a pledgee deceives the pledgor into pledging understated securities. In order to capitalize on its fraud, the pledgee must foreclose and sell the securities. Any windfall in the foreclosure sale, *i.e.*, proceeds in excess of pledgor's debt, must be returned to the pledgor. See *supra* note 9 and accompanying text; *cf.* McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974) (pledgee did not have to foreclose on pledged stock in order to capitalize on its fraud since land underlying asset value of pledged stock was seized instead. A quite different problem arises when a defaulting pledgor, whose stock is being foreclosed upon, alleges fraud in the foreclosure process. See, *e.g.*, Dopp v. Franklin National Bank, 374 F. Supp. 904 (S.D.N.Y. 1974) (standing to challenge an alleged fraud granted to pledgor when foreclosure sale price of stock was intentionally understated by pledgee and could not satisfy pledgor's debt).

11. For purposes of this discussion "antifraud provisions" shall refer to: § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1976) [hereinafter referred to as Section 17(a)]; § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) [hereinafter referred to as Section 10(b)]; and Securities & Exchange Commission [hereinafter referred to as SEC] Rule 10b-5, promulgated under Section 10(b), 17 C.F.R. § 240.10b-5 (1981) [hereinafter referred to as Rule 10b-5].

Section 17(a) provides:

It shall be unlawful for any person *in the offer or sale of any securities* by use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in a transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976) (emphasis added).

Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

...

- (b) to use or employ, *in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered*, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and

securities acts.¹²

The prevailing view among legal scholars is that it is more advantageous for a defrauded pledgee to sue under the federal acts than under state law. Among the procedural advantages are the availability of nationwide venue and service of process,¹³ a relaxed privity requirement enabling a broader class of defendants¹⁴ and liberal rules concerning discovery,¹⁵ pleading and joinder.¹⁶ Furthermore, the common law elements of fraud have either been eliminated or modified, making it easier to establish a claim of actionable fraud under the federal securities acts as opposed to state laws.¹⁷ Implicit in the suggestion that a defrauded pledgee will benefit more by suing under the federal acts is that defrauded pledgees have standing to sue under the antifraud provisions of the federal securities acts.

Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976) (emphasis added).

Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange,

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security*.

17 C.F.R. § 240.10b-5 (1981) (emphasis added). Rule 10b-5 was adopted by the SEC in 1942 to effectuate the provisions of Section 10(b). See SEC EXCHANGE ACT RELEASE No. 3230 (May 21, 1942). For a comparison of other major antifraud provisions, see 1 A. BROMBERG, *SECURITIES LAW FRAUD* §§ 4.6, 8.2 (1971) [hereinafter cited as BROMBERG] (table listing features of each provision).

12. The Securities Act of 1933, 15 U.S.C. §§ 77a--77aa (1976) [hereinafter referred to as 1933 Act], and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a--78kk (1976) [hereinafter referred to as 1934 Act, and collectively with the 1933 Act as "securities acts" or "the Acts"]. Although a private right of action has been recognized by the courts under both Acts, the availability of such a right under section 17(a) has been criticized in recent years. See Horton, *Section 17(a) of the 1933 Securities Act—the Wrong Place for a Private Right*, 68 Nw. U.L. REV. 44 (1973).

13. 15 U.S.C. § 78aa (1976).

14. See BROMBERG, *supra* note 11, at § 2.5(3).

15. See CARY, *CASES AND MATERIALS ON CORPORATIONS* 794 (4th ed. 1969).

16. See Comment, *Commercial Notes and Definitions of Security Under Securities Exchange Act of 1934: A Note is a Note is a Note?* 52 NEB. L. REV. 478, 509 (1973).

17. See *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (discussion of elements). See also A. JACOBS, *THE IMPACT OF RULE 10b-5* §§ 60, 60.1 (1979).

This comment will focus on the question of whether a pledge of stock is a sale and, thus, a protected transaction for purposes of section 17(a) of the 1933 Act¹⁸ and, by extension, of section 10(b) of the 1934 Act.¹⁹ A preliminary examination of the history and purpose of the securities acts is followed by a review of the case law on this issue up to and including the recent United States Supreme Court decision in *Rubin v. United States*.²⁰ Finally, a parallel application of *Rubin's* section 17(a) holding is considered and applied to section 10(b).

LEGISLATIVE HISTORY AND PURPOSE OF THE SECURITIES ACTS

Origin and Intent

Prior to 1933, securities regulation was the exclusive province of state "blue sky laws."²¹ The first state "blue sky" act was passed in Kansas in 1911. The concept of state securities regulation became so popular that, within two years, twenty-three states adopted securities legislation. By the beginning of the Great Depression of 1929, virtually all state jurisdictions had some variation of securities legislation.²²

Securities legislation among the states, however, lacked national uniformity. Consequently, a movement to create a federal agency to regulate trading of securities in interstate commerce began in the mid-1920s. This trend became a critical national concern in the aftermath of the stock market crash of 1929.²³

18. 15 U.S.C. § 77q(a) (1976).

19. 15 U.S.C. § 78j(b) (1976). Rule 10b-5 is presumed, for discussion purposes, to apply to discussions of Section 10(b).

20. 449 U.S. 424 (1981).

21. One author maintains that the label "blue sky laws" evolved from the unscrupulous practices of early securities salesmen which were likened to sellers "of building lots in the blue sky." L. LOSS & E. COWETT, *BLUE SKY LAWS*, 7 n.22 (1958). Another proposed origin is *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) where it was said that early state securities acts were passed to control "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Id.* at 550. At any rate, the distinction is somewhat nebulous.

22. See Long, *State Securities Regulation—An Overview*, 32 OKLA. L. REV. 541, 542 (1979) [hereinafter cited as Long].

23. 1 L. LOSS, *SECURITIES REGULATION* 119-21 (2d ed. 1961) [hereinafter cited as LOSS]. The stock market crash was really the "volcanic eruption" of a multitude of irregular and fraudulent investment schemes. Typically in the post-World War I period, a scheme would be contrived and state regulation would follow *ex post facto*. To illustrate, in 1918, the Attorney General of Illinois was asked to decide whether a contract for the purchase and maintenance of brood sows was a "security." He concluded that under the applicable Illinois statute, such a scheme would not be a "security." The next year, the Illinois legislature revised the definition of "security" so that such an investment contract or profit-sharing agreement would be encompassed in the statute. This type of response-oriented legislation triggered a domino effect in the investment field so that ingenious, but often fraudu-

The movement for federal intervention in the securities market culminated in the passage of the Securities Act of 1933²⁴ and the Securities Exchange Act of 1934.²⁵

Congress enacted the 1933 Act with the express purpose of providing "full and fair disclosure of the character of securities . . . and to prevent frauds in the sale thereof."²⁶ The 1934 Act provides for "regulation of securities exchanges and of over-the-counter markets" and prevents "inequitable and unfair practices on such exchanges and markets."²⁷

The 1933 Act is designed to regulate the initial distribution of securities to the public while the 1934 Act is directed at public trading after the initial distribution. Both Acts are primarily disclosure statutes. Neither Act regulates the quality of securities sold and traded in the public domain. As long as disclosure requirements are met, the public is entitled to buy and, more importantly, sellers are entitled to offer virtually worthless stock.²⁸ Thus, the importance of stringent application of disclosure rules and strict compliance under the antifraud provisions is readily apparent.

The origins of the antifraud provisions can be traced to the New Deal response to the "financial debacle of the 1920's, inves-

lent, get-rich-quick schemes sprouted throughout the country. The legislative confusion and ensuing public panic was the catalyst for the stock market crash of 1929. *See generally* LONG, *supra* note 22, at 542-43. For a comprehensive legislative history of the Acts, *see* J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 (1973).

24. 15 U.S.C. §§ 77a-77aa (1976).

25. 15 U.S.C. §§ 78a-78kk (1976).

26. Preamble to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976). The Senate Report on the bill, which ultimately became the 1933 Act, stated:

The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities . . . and providing protection against fraud and misrepresentation.

The aim is to prevent further exploitation of the public . . . , to place adequate and true information before the investor, to protect honest enterprise . . . [and] to restore the confidence of the prospective investor

S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933). *See also* H. R. REP. NO. 85, 73d Cong., 1st Sess. 1 (1933); 77 CONG. REC. 2983 (1933) (statement of Sen. Fletcher, sponsor of the bill).

27. Preamble to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976). Professor Loss has commented that the 1934 Act has four basic purposes: "to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets, and to control the amount of the Nation's credit which goes into those markets." LOSS, *supra* note 23, at 130-31.

28. *See generally*, J. S. HOFFMAN, INTRODUCTION TO THE SECURITIES LAWS (P.L.I. No. 277, 1977).

tigations of which revealed widespread fraud, manipulation and victimization of public investors by concealment of relevant information."²⁹ Section 17(a) of the 1933 Act was enacted to prevent fraudulent interstate transactions. Section 10(b) of the 1934 Act was enacted to prevent false and misleading trading practices. By passing these statutes, Congress was attempting to quell the proliferation of deceptive investment schemes. Congress was equally concerned that investors have equal access to material securities information.³⁰ The antifraud provisions, and the Acts as a whole, have been described as "remedial legislation."³¹ They are intended to deter fraudulent conduct and provide remedies for victims, in connection with the offer, sale or purchase of securities.

29. See BROMBERG, 1 SECURITIES FRAUD & COMMODITIES FRAUD § 2.2, at 110 (1979).

For the legislative evolution of § 17(a), see *Aaron v. SEC*, 444 U.S. 914 (1979); for the legislative evolution of § 10(b), see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976); for the interesting origin of rule 10b-5, see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 767 (1975) (Blackmun, J. dissenting), for the proposition that rule 10b-5 derived from section 17(a). See also *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly concurring), *cert. denied*, 394 U.S. 976 (1979).

30. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 131 (1972). The congressional purpose in enacting § 17(a) is best summarized in the Senate Report:

The purpose of this bill is to protect the investing public and honest business The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown tired to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).

The congressional purpose for § 10(b) is found in a statement by one of its draftsmen, Thomas Corcoran:

Subsection (c) [9(c) of H.R. 7952 - later § 10(b)] says, 'Thou shalt not devise any other cunning devices.'

* * *

Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.

HEARINGS ON H.R. 7852 AND H.R. 8720 BEFORE THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 73d Cong., 2d Sess. 115 (1934); see also *Chiarella v. United States*, 445 U.S. 222 (1980) (§ 10(b) as a catch-all clause).

31. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The civil enforcement mechanism of these provisions includes both express and implied remedies. For a list of express sanctions see *Bromberg*, *supra* note 11, at § 2.7; for the origin of an implied remedy, see *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

Definitional Problems and Judicial Interpretation

Since the enactment of the 1933 and 1934 Acts, there have been repeated demands upon the federal courts to define the proper scope of the securities laws.³² These demands, unfortunately, have led to incongruous results. It is not uncommon for participants in an "original" investment-type scheme to be perplexed as to whether or not the plan is subject to the securities laws. One commentator has cautioned that "[t]he definition of the term 'security' . . . is for the most part one of the best kept secrets in recent legal history."³³

Nevertheless, the favored judicial approach is to construe the statutes liberally.³⁴ The obvious basis of this approach is the caveat prefacing the definitional sections of each Act: a definition will apply "unless the context otherwise requires."³⁵ As a result of this phrase, the courts must examine the "surrounding factual circumstances" of the challenged transaction or instrument³⁶ in order to determine the applicability of the securities statutes. This essentially "substance over form" approach broadens coverage of the Acts.

The United States Supreme Court specifically rejected a literal application of the securities acts in *United Housing Foundation, Inc. v. Forman*.³⁷ Even before *Forman*, the courts had

32. See generally Hannan & Thomas, *supra* note 2, at 219-25; see also Newton, *A Look at the Montana Securities Acts and Its Relation to the Federal Securities Acts*, 26 MONT. L. REV. 31 (1964); Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

An example of a transaction which has been highly scrutinized as to its applicability to the securities laws is the garden-variety commercial note. See generally Lipton & Katz, "Notes" are not Always Securities, 30 BUS. L. 763 (1975); Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1976); Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973).

33. Hannan & Thomas, *supra* note 2, at 219.

34. See generally, Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728 (1961). There is some confusion on this point. On at least five occasions the U.S. Supreme Court has rebuked the lower courts for reading the term "security" too restrictively. Hannan & Thomas, *supra* note 2, at 219. Yet, on other occasions the same Court has held to a rigid and narrow formula in defining securities transactions. *Id.* at 220.

35. 15 U.S.C. §§ 77b, 78c (1976). See also SEC v. National Securities, Inc., 393 U.S. 453, 466 (1969).

36. *Emisco Indus., Inc. v. Pro's, Inc.*, 543 F.2d 38, 39 (7th Cir. 1976) (*economic context* of 5-year note given to purchase a business indicated that note was not a "security," notwithstanding the fact that statute defining "security" includes "any note").

37. 421 U.S. 837, 850 (1975) (literal use of term "stock" for shares sold by a cooperative not considered a securities transaction merely because statutory definition refers to "stock"); cf. *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1132 (2d Cir. 1976) (party asserting that note was not within securities provision had burden of showing that "context otherwise

adopted a nonliteral approach in defining securities. This early approach, often applicable to investment contracts, arose out of *SEC v. Howey Co.*³⁸ in 1946. That case fashioned a test known as the Howey formula: an investment plan qualifies if profits are expected to be derived from the efforts of others.³⁹ This approach, although strictly followed by the courts for several decades, has recently been criticized as too rigid and ill-suited to meet the exigencies of modern promotional schemes.⁴⁰

A widely accepted nonliteral approach is the "economic realities" approach⁴¹ which concentrates on motivation, control and the risk of economic loss in a subject transaction. If a scheme is such that venture capital is obtained from an "investor" and the risk of losing that capital shifts to the "investor," that "investor" is entitled to the protection of the securities laws.⁴²

requires" removes it from meaning of "securities"). The *Forman* court noted that "[w]ith the exception of the Second Circuit, every court of Appeals recently to consider the issue has rejected the literal approach" 421 U.S. at 849 n.14. See also *National Bank of Commerce v. All Amer. Assurance Co.*, 583 F.2d 1295, 1301 (5th Cir. 1978) (Supreme Court discounted the so-called literal approach).

38. 328 U.S. 293 (1946).

39. The text of Justice Murphy's definitional test reads:

[A]n investment contract for purposes of the Securities Acts means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

Id. at 298-99.

40. See generally Coffey, *The Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Hannan & Thomas, *supra* note 2; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

41. One author has attempted to provide a framework for the "economic realities" approach by providing seven questions:

- (1) What is the participant asked to contribute to the enterprise?
- (2) Is there a common enterprise?
- (3) Is the participant led to expect a profit?
- (4) How does the promotor characterize the promotion?
- (5) Where does the risk of loss fall?
- (6) Is the participant's contribution risk capital?
- (7) Who is in control of the venture?

Hannan & Thomas, *supra* note 2, at 236-49.

For examples of application of the "economic realities" approach, see *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975) (shares purchased for housing not investment); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559-61 (1979) (participation in non-contributory, compulsory pension plan motivated by desire for livelihood not investment).

42. Risk analysis is critical to this approach. The analyst must distinguish between normal "commercial" risks, which are unprotected by securities laws, and "investment-type" risks, which are protected.

A final nonliteral approach, similar but not interrelated to the "economic realities" approach, is the "commercial/investment dichotomy."⁴³ This test considers the duality of subject transactions and looks to their basic nature or context in discerning whether it is investment-oriented or not. When an "investor" contributes capital to an "investee" with the expectation that a return will be realized from the "investee's" employment of the capital, the transaction is deemed speculative, and thus investment-oriented.⁴⁴

The Pledge Revisited

As mentioned previously, the pledge at common law is distinguishable from a sale since a pledge involves a transfer of possession only and not of title.⁴⁵ Under the securities acts, however, and particularly under the antifraud provisions, a

Whenever some future performance is promised to the customer of an enterprise, there is the commercial risk that the promisor will not perform or that intervening insolvency of the promisor will prevent or delay performance. These types of 'normal' commercial risks, without more, do not shift the principal risk to the customer.

Hannan & Thomas, *supra* note 2, at 242-43.

Conversely, if an enterprise were to solicit the customer merely as a "conduit" of the market place, the principal risk of loss would lie with the customer-investor. *Id.*

43. This approach evolved out of a series of three cases primarily concerned with notes as securities: *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972). The *Bellah* court pioneered the phrase "commercial/investment dichotomy." 495 F.2d at 1112 n.3. For a discussion of this approach, see generally Comment, *Bank Loan Participations as Securities: Notes, Investment Contracts, and the Commercial/Investment Dichotomy*, 15 DUQ. L. REV. 261 (1976-77). For examples of application of this approach, see *McClure v. First Nat'l Bank*, 497 F.2d 490, 493 (5th Cir. 1974), *cert. denied*, 420 U.S. 903 (1975) (notes excluded from coverage because underlying transaction not investment-oriented); *National Bank of Commerce v. All Amer. Assurance Co.*, 583 F.2d 1295, 1301-02 (5th Cir. 1978) (notes excluded due to commercial nature).

44. Courts have had difficulty applying the commercial/investment dichotomy because even commercial transactions involve a degree of speculation. Consequently, some courts have developed a check list:

1. The amount of time between issuance and maturity;
2. whether the proceeds are to be used to purchase consumer goods or services;
3. the risk of loss on the note, using the extent of collateralization and the relationship between the amount borrowed and the size of the borrower's business as indications of the degree of risk;
4. whether the notes were issued to a single party or to a large class of investors;
5. how the instrument is characterized in the business community.

Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976). See also *C.N.S. Enter., Inc. v. G. & G. Enterprises*, 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

45. See *supra* note 4 and accompanying text.

pledge is not so readily distinguishable.⁴⁶ The difficulty lies in the liberal definitions of an "offer or sale" in the 1933 Act⁴⁷ and "purchase or sale" in the 1934 Act.⁴⁸ On their face,

[s]tatutory definitions of 'sale' would appear broad enough to embrace a transfer of a security interest in stock since a 'sale' under the 1933 Act includes 'every . . . disposition of a[n] . . . interest in a security for value.' The 'or otherwise dispose of' language of the 1934 Act definition [of sale] could also be interpreted to extend to a pledge transaction.⁴⁹

THE CONTROVERSY IN THE CIRCUITS

The expansion of the common law concept of "sale" under the Acts placed a direct definitional problem before the courts: whether a pledge of stock constituted a sale under the securities acts. This problem was further complicated by the lack of uniformity in definitional approaches adopted by the courts.

In 1960, the Second Circuit, in *SEC v. Guild Films Co.*,⁵⁰ took the initiative in holding that a pledge of stock was a "sale" under the Acts.⁵¹ The issue before the court was whether pledgee banks fell within the definition of "underwriter" in section 2(11) of the 1933 Act.⁵² In order to decide, the court held that a pledge of stock was a sale within the meaning of section 2(3) of the 1933 Act.⁵³ In this manner, the court refused an alleged exempted status of pledgee banks and found them liable under section 5 of the 1933 Act⁵⁴ for distributing unregistered securities in a foreclosure sale.⁵⁵

46. See, e.g., *infra* note 63 and accompanying text.

47. The terms "offer" and "sale" are defined in section 2(3) of the 1933 Act:

The term 'sale' or 'sell' shall include every contract of sale or *disposition of a security or interest in a security, for value*. The term . . . 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

15 U.S.C. § 77b(3) (1976) (emphasis added).

48. The term "sale" is defined in § 3(a)(14) of the 1934 Act as "any contract to sell or *otherwise dispose of*." 15 U.S.C. § 78c(a)(14) (1976) (emphasis added); the term "purchase" is defined in § 3(a)(13) of the 1934 Act as "any contract to buy, purchase, or *otherwise acquire*." 15 U.S.C. § 78c(a)(13) (1976) (emphasis added).

49. *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040-41 (7th Cir. 1979).

50. 279 F.2d 485 (2d Cir. 1960), *cert. denied*, 364 U.S. 819.

51. Prior to 1960, the proposition that a pledge was not a "sale" under the securities acts was generally upheld. See *Loss, supra* note 23, at 517.

52. 15 U.S.C. § 77b(11) (1976). This section defines an "underwriter" (expressly not exempt from registration) as "any person who has *purchased*." *Id.* (emphasis added).

53. 15 U.S.C. § 77b(3) (1976).

54. 15 U.S.C. § 77e (1976).

55. *SEC v. Guild Films Co.*, 279 F.2d 485, 490 (2d Cir. 1960), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819. The *Guild* case is prima-

The significance of the Second Circuit opinion lies in the court's holding on the scope of "purchase" as applied under section 2(11). The court pointed out that the term, although not defined in the 1933 Act, should be interpreted in a manner complementary to the definition of "sale," which is defined in section 2(3). Under that definition, pledgee banks qualify as "purchasers" vis-a-vis their acceptance of a collateral interest in pledged stock.⁵⁶ The disadvantage in using *Guild* as precedent under the antifraud provisions is that *Guild* involved an action for registration violations and not an action for fraud.⁵⁷ Nevertheless, *Guild* spurred a series of conflicting court of appeals decisions during the next two decades.⁵⁸

The Seventh Circuit in *SEC v. Dolnick*,⁵⁹ held that a pledge of unregistered securities constituted a "sale" for purposes of registration provisions of the 1933 Act. Furthermore, misrepresentations as to the marketability of pledge stock provided a basis for a section 10(b) cause of action. The court reasoned that since the pledgor had disposed of an interest in a security, the transaction qualified under section 2(3) as a "sale."⁶⁰ The *Dolnick* decision, however, is a weak antifraud precedent since the court, as in *Guild*, was concerned with a registration violation under section 5 of the 1933 Act.

In contrast, the Fifth Circuit in *McClure v. First National Bank of Lubbock*,⁶¹ held that a pledge of stock in a privately ne-

rily concerned with the protection of investors by requiring that a registration statement be filed with the SEC. The plaintiff in the case sought a preliminary injunction to restrain delivery of unregistered securities already sold by the pledgee bank. The Second Circuit upheld the granting of an injunction. *Id.*

In support of its rejection of the pledgee bank's "bona fide pledgee" defense, the Second Circuit relied on Congress's rejection of an express exemption for foreclosures pursuant to a "good faith" failure to register. *Id.* at 489. See generally Comment, *The Guild Films Case, The Effect of "Good Faith" in Foreclosure Sales of Unregistered Securities Pledged as Collateral*, 46 VA. L. REV. 1573, 1584 (1960) [hereinafter cited as *Good Faith*].

56. *SEC v. Guild Films Co.*, 279 F.2d 485, 489 (2d Cir. 1960), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819.

57. For further criticism of the *Guild* precedent, see Comment, *Securities Law—Rule 10b-5 Standing—Pledge of Securities in a Loan Transaction Held to Constitute a Sale—Mallis v. FDIC*, 52 N.Y.U. L. REV. 651, 660-61 (1977).

58. See LOSS, *supra* note 23, at 649; Pierce, *Securities and Exchange Commission v. Guild Films Co.*, 16 BUS. LAW. 603 (1961); *Good Faith*, *supra* note 55, at 1584.

59. 501 F.2d 1279 (7th Cir. 1974). In *Dolnick*, a broker had engaged in pledging unregistered securities for a bank loan and then attempting to sell the securities in repayment of the loan.

60. *Id.* at 1283.

61. 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). In *McClure*, a note and trust deed were given as collateral in a corporate loan.

gotiated renewal of a bank loan did not constitute a "sale" of a security for purposes of section 10(b) of the 1934 Act. The court stressed that "mere acceptance of a stock pledge as collateral in a privately negotiated transaction . . . does not, of itself, bring it within the scope of the federal securities acts."⁶² *McClure* distinguished *Guild* on the grounds that it arose under section 5 of the 1933 Act and involved a sale following default. The Fifth Circuit indicated its reluctance to extend antifraud protection absent a foreclosure on the pledged stock—an argument which unfortunately follows the common law notion of "sale" and the importance of title.

In *United States v. Gentile*,⁶³ the Second Circuit held that a pledge of securities was a "sale" for purposes of a criminal proceeding under section 17(a). The court rejected *McClure's* requirement that title pass in order to find a "sale"; such a requirement would be unreasonably dependent upon subsequent events (foreclosure or subsequent sale).⁶⁴ As support for its holding, the *Gentile* court noted that "the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as an indisputable basis for statutory regulation of securities transactions."⁶⁵ *Gentile* is the first persuasive court of appeals opinion advocating antifraud protection for pledges of stock. Its shortcoming, however, is its confinement to a section 17(a) action under the 1933 Act; it does not extend its holding to a section 10(b) action under the 1934 Act.

Next, in *Mallis v. Federal Deposit Insurance Corp.*,⁶⁶ the Second Circuit granted standing under section 10(b) on the grounds that a "sale" had transpired when the plaintiff banks

Subsequently, a pledge of stock in the corporation was also given in support of a loan extension.

62. *Id.* at 495.

63. 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). *Gentile* involved a criminal prosecution for a fraudulent pledge of unauthorized securities.

64. *Id.* at 467 n.6.

65. *Id.* at 467.

66. 568 F.2d 824 (2d Cir. 1977), *cert. granted sub mon.* Bankers Trust Co. v. Mallis, 431 U.S. 928, *cert. dismissed as improvidently granted sub nom.*, Bankers Trust Co. v. Mallis, 435 U.S. 381 (1978), *reh'g denied*, 436 U.S. 915 (1979). The unusual facts giving rise to the fraud in *Mallis* were as follows: two dentists loaned money to an attorney to finance the purchase of securities from a third party. The attorney delivered the securities to the dentists as collateral for the loan. When the attorney defaulted on the loan, the dentists learned that the stock was worthless and brought this action under § 10(b) and rule 10b-5. The Second Circuit held that plaintiffs were "purchasers" when they accepted the collateral and that Bankers Trust, which had originally released the securities to the dentists, was a "seller."

accepted pledged securities as collateral. The court strongly rejected the *McClure* requirement of foreclosure and reiterated its rationale, previously stated in *Gentile*, that full title was not determinative in finding a "sale."⁶⁷ The court unhesitatingly applied its section 17(a) holding in *Gentile* to a section 10(b) cause of action.⁶⁸ Thus, *Mallis* represents the strongest court of appeals decision in favor of extending protection to pledges under both Acts.

The Fifth Circuit concluded in *National Bank of Commerce v. All American Assurance Co.*,⁶⁹ that a commercial loan secured by a pledge of worthless stock does not satisfy the commercial/investment test and, therefore, could not be protected by either section 17(a) or section 10(b). The court acknowledged that as a matter of policy, the securities acts could embrace a pledge but withheld their application due to the pure commercial aspects of the transaction. *All American* concentrated on the contrast between the rights and risks of a pledgee as compared with a seller. The holding is somewhat weak since it applies what is basically an "economic realities" approach in support of a commercial/investment argument.⁷⁰

The Sixth Circuit, in *Mansbach v. Prescott, Ball and Turben*,⁷¹ held that a pledge of stock to a broker-dealer was a "purchase" or "sale" under section 10(b) and applied it to rule 10b-5. The court found the Second Circuit holdings in *Mallis* and *Gentile* more persuasive than the Fifth Circuit holdings in *All American* and *McClure*. After summarily adopting the Second Circuit position, the *Mansbach* court attempted to reconcile its holding with the Fifth Circuit cases by applying the commercial/investment test to the broker-dealer relationship.⁷² It is unclear whether this test or Second Circuit authority was

67. *Id.* at 830.

68. *Id.* at 828-29.

69. 583 F.2d 1295 (5th Cir. 1978). In this case, a new issuance of stock, which was not approved by the Board of Directors, was worthless. Plaintiff bank accepted the unauthorized stock as pledge collateral and when the issuing company went bankrupt, sought relief under § 10(b) and § 17(a). The court applied the commercial/investment test in concluding that the loan was essentially commercial and, therefore, unprotected under the securities laws. *Id.* at 1301.

70. *Id.* at 1300. Since the court relies on the *rights* and *risks* of the parties, the more appropriate test would be the "economic realities" of the subject transaction. *See supra* notes 41 & 42.

71. 598 F.2d 1017 (6th Cir. 1979). In this case, plaintiff pledged corporate bonds to a brokerage firm as collateral for option trading. When a dispute arose over plaintiff's account, the pledgee firm refused to release a few of the bonds and this action ensued under § 10(b) and rule 10b-5.

72. *Id.* at 1029. *See supra* note 11.

controlling in the *Mansbach* holding; yet the value of *Mansbach* as a precedent is only slightly weakened as a result.

Finally, the Seventh Circuit, in *Lincoln National Bank v. Herber*,⁷³ denied antifraud protection under either Act to a bank which had accepted stock as collateral in a commercial loan transaction. Absent default and foreclosure, a pledge of stock in an ordinary commercial context was not the sort of transaction that would affect the securities market.⁷⁴ *Herber* advanced the Fifth Circuit position in the same fashion that *Mansbach* strengthened the Second Circuit position. Following *Herber*, the division in the circuit courts was clear; the Second and Sixth Circuits relied on investment risk and "disposition of an interest" arguments⁷⁵ while the Fifth and Seventh Circuits relied on the title/foreclosure and commercial/investment rationales.⁷⁶

THE RUBIN DECISION

The United States Supreme Court partially resolved the controversy among the circuits in *Rubin v. United States*.⁷⁷ *Rubin* affirmatively established that a pledge of stock is construed as an "offer" or "sale" of a security within the meaning of section 17(a) of the 1933 Act.⁷⁸ Whether a pledge of stock would equally apply to section 10(b) of the 1934 Act was not specifically before the Court, and thus was not addressed.

Defendant Rubin, an officer and agent for a financially troubled company, approached Bankers Trust Company (Bankers) to secure a "bail-out" loan. Bankers refused Rubin's \$5 million loan request and instead loaned him \$50,000. Bankers stipulated that additional financing would be available if adequate collateral and financial data were presented.⁷⁹ Thereafter, Rubin reapproached Bankers with false and misleading financial statements and a pledge of worthless stock as collateral.⁸⁰ Rubin continued to deceive the bank on the continuing

73. 604 F.2d 1038 (7th Cir. 1979). The case involved an attorney who, acting as trustee of a trust with "assets" consisting of counterfeit securities, obtained a loan by pledging the counterfeit securities to a third party bank. Plaintiff bank then participated in the loan to the attorney and brought this action under § 17(a) and § 10(b) when the fraud was discovered upon default.

74. *Id.* at 1044.

75. See *supra* notes 63, 64 & 66 and accompanying text.

76. See *supra* notes 61, 68 & 72 and accompanying text.

77. 449 U.S. 424 (1981).

78. *Id.* at 428-31.

79. *Id.* at 425.

80. *Id.* at 425-26.

value of the securities by manipulating stock quotations.⁸¹ Based upon these misrepresentations, Bankers loaned Rubin \$475,000. When Bankers finally became suspicious and called in the loan, Rubin's company was unable to pay.⁸² Bankers brought suit against Rubin and the company for collection on the notes.⁸³

Rubin was convicted, *inter alia*, of violation of section 17(a) of the 1933 Act. The Court of Appeals for the Second Circuit affirmed, and limited certiorari was granted by the Supreme Court to review the section 17(a) conviction.⁸⁴

The Supreme Court rejected Rubin's argument that the pledgee's implied power to dispose of the stock could not ripen into full title until foreclosure. The Court stated: "[A]lthough pledges transfer less than absolute title, the interest thus transferred nonetheless is an 'interest in a security' within the meaning of section 2(3) of the 1933 Act."⁸⁵

The *Rubin* Court next reviewed the legislative history of the term "sale." The definition of "sale" in the 1933 Act was adopted practically verbatim from a model "blue sky" statute.⁸⁶ That model act's definition of a sale was held to include pledges in a 1932 circuit court decision.⁸⁷ Subsequent enactment of the 1933 Act, without excepting pledges, indicated congressional intent to give the definition of "sale" the broad coverage afforded under prior case law.⁸⁸

Finally, the *Rubin* Court applied an "economic realities" approach and held that the risk assumed by a lender when it accepts pledged stock as collateral is similar to the risk that an investor undertakes in purchasing stock. Each transferee relies on the continuing value of the securities and each depends on the transferor's representations. Furthermore, protecting misled stock pledgees comports with the legislative purpose of the 1933 Act.⁸⁹

ANALYSIS

The *Rubin* Court clearly adopted the Second and Sixth Circuits' positions articulated in *Gentile* and *Mallis*, respectively.

81. *Id.* at 426-27.

82. *Id.* at 427.

83. *Id.*

84. *Id.* at 428.

85. *Id.* at 429.

86. *Id.* at 430 n.7.

87. *Cecil B. DeMille Prod., Inc. v. Wollery*, 61 F.2d 45 (9th Cir. 1932).

88. *Rubin*, 449 U.S. at 430.

89. *Id.* at 431.

Rubin rejected by implication the Fifth and Seventh Circuits' positions represented by *All American* and *McClure*. This rejection, however, presumes that the two sets of circuit court positions are mutually exclusive.

The *Rubin* holding rejects the argument that title must pass in all cases of a "sale" under the antifraud provision. The Court appropriately recognizes a fundamental distinction between common law and statutory concepts of "sale." The remedial purposes of the securities acts mandate a general departure from the common law requirement that title pass in order to recognize a "sale."

Assuming, *arguendo*, that the title requirement could not be obviated, the statutory definition of "sale" contained in section 2(3) of the 1933 Act,⁹⁰ nevertheless, recognizes a pledge. The phrases "every . . . disposition of" and "interest in a security," given their commonly understood meaning, make unmistakable an intent to include pledges since, as mentioned, a pledgor disposes of an inchoate property interest.⁹¹ The Supreme Court has stressed, on several occasions, that the operative language of the securities statutes should be given its "commonly accepted meaning."⁹²

The *Rubin* Court examined the pledge of stock transaction from the lender's standpoint and concluded that the "economic considerations and realities" are much akin to the "normal" investor. The pledgee's risk and dependency on representations are investment-oriented and, thus, require the protection of the securities laws.⁹³ This argument, identical to *Gentile*, is a sound application of the "economic realities" approach.⁹⁴

Rubin does not address, however, the obvious commercial nature of the pledge of stock involved in the case. The Court ignores the commercial/investment dichotomy, perhaps because applying such a test might diminish the value of *Rubin* as a precedent. Regardless, an essential concern at the root of the commercial/investment dichotomy deserves discussion. That

90. 15 U.S.C. § 77b(3) (1976).

91. See *supra* note 4 and accompanying text. Whether the basis for including pledges is "disposition" or "interest" is simply a matter of choice. Each argument is equally sound. Compare the majority opinion of Chief Justice Burger, 449 U.S. at 424-31 with the concurring opinion of Justice Blackmun at 431-32. Burger emphasizes that antifraud protection should be afforded to recipients of full title and "defeasible interests" in a security. Blackmun maintains that a pledge is a "disposition" *per se*.

92. *Ernst & Ernst v. Hockfelder*, 425 U.S. 185, 199 (1976).

93. *Rubin*, 449 U.S. at 427.

94. See *supra* notes 41-42 and accompanying text.

concern arises out of *Blue-Chip Stamps v. Manor Drug Stores*⁹⁵ which held that section 10(b) standing is limited to *actual* purchasers and sellers. If pledgees of stock in pure commercial loan situations have standing to sue, the classes of potential plaintiffs may exceed the proper scope of the Acts pursuant to *Blue-Chip*. This argument has little merit since the claimed limitation to *actual* purchasers and sellers—contemplating full passage of title—is a requirement, as has been shown, which is not statutorily imposed in either the 1933 or 1934 Acts.⁹⁶ The transfer of “an interest,” *e.g.*, a lender’s security interest, is all that is imposed.

Parallelism between Section 17(a) and Section 10(b)

A significant but unresolved issue flowing from the *Rubin* decision is whether a pledge of stock constitutes a “sale” for purposes of the antifraud provisions in *both* the 1933 and 1934 Acts. The courts are divided on the question of using precedents under one securities act as authority for a holding under the other. The prevailing viewpoint, upheld by the United States Supreme Court, is that the 1933 and 1934 Acts should be interpreted as “one body of law.”⁹⁷ The Supreme Court in a landmark securities decision, *Ernst & Ernst v. Hochfelder*,⁹⁸ pointed out that the two Acts are “interrelated components” of a single federal regulatory scheme.⁹⁹ This statement has prompted the lower courts to apply certain precedents under the 1933 and 1934 Acts interchangeably.

The minority viewpoint is to treat precedents under the 1933 and 1934 Acts separately. This treatment received limited approval in *SEC v. National Securities, Inc.*¹⁰⁰ In that case, the Court cautioned that “the same words may take on different coloration in different sections of the securities laws.”¹⁰¹ Thus, a segregated definitional application was recommended. Undue

95. 421 U.S. 723 (1975). *Blue-Chip* adopted a rule set forth in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956, which banned suits by *potential* buyers and sellers of securities.

96. *See supra* note 47.

97. *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1968). The *Tcherepnin* Court, in holding that withdrawable capital shares were securities under the 1934 Act, indicated that “[t]he same Congress which passed the Securities Act of 1933 approved the Securities Exchange Act of 1934, and the definition of security contained in the 1934 Act is virtually identical to that in the earlier enactment.” *Id.* at 342. *See also* Hannan & Thomas, *supra* note 2, at 220-23 nn.6-19. For a discussion of the major differences in the Acts, *see* BROMBERG, *supra* note 11, at § 4.6.

98. 425 U.S. 185 (1975).

99. *Id.* at 206.

100. 393 U.S. 453 (1969).

101. *Id.* at 466.

reliance on technical distinctions between the Acts, however, creates a bottleneck in securities laws enforcement. Bifurcated definitions are more difficult to apply than unified ones. That is undoubtedly one of the reasons why the minority view has not been widely accepted.

There is convincing authority that, despite slight differences between the Acts, the definitions of "purchase" and "sale" are "functionally equivalent."¹⁰² It is certainly apparent that "sale" as used in section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are in *pari materia*. It is also clear that "purchase" should complement "sale."¹⁰³ Therefore, it follows that these terms, as used under each Act, should be construed together. The *Mallis* court specifically upheld this rationale:

We believe that the rationale underlying our holding in *Gentile* with respect to sections 2(3) and 17(a) of the 1933 Act is persuasive authority for the holding that a pledge constitutes a 'contract to sell or otherwise dispose of' a security within the meaning of section 3(14) of the 1934 Act. Accordingly, on the facts of this case, we hold that both a 'sale' and a 'purchase' may be cognizable under section 10(b) of the 1934 Act.¹⁰⁴

The inescapable conclusion is that section 17(a) holdings should apply with equal force to section 10(b) causes of action. Hence, *Rubin* should be construed as mandating that pledges of stock receive antifraud protection under *both* the 1933 and 1934 Acts.

Other Policy Considerations

As mentioned before, the securities acts, and specifically the antifraud provisions, are considered "remedial" legislation.¹⁰⁵ This does not require that only investors benefit from the legislation. The securities laws should not be limited to preserving the integrity of the securities market alone. Wherever possible, the administration of these statutes should also promote "high standards of business ethics."¹⁰⁶ *Rubin* achieves the result of promoting fair-play in lending transactions in which stock is pledged.

With reference to lending institutions, the prevention of stock price manipulation which impinges on the "fair valuation

102. See *National Bank of Commerce v. All Amer. Assurance Co.*, 583 F.2d 1295, 1298 (5th Cir. 1978); see also *McClure v. First Nat'l. Bank*, 497 F.2d 490, 493 n.1, (5th Cir.), *cert. denied*, 420 U.S. 903 (1975).

103. *SEC v. Guild Films Co.*, 279 F.2d 485, 489 (2d Cir. 1960) *cert. denied*, 364 U.S. 819.

104. *Mallis v. Federal Dep. Insur. Co.*, 568 F.2d 824, 830 (2d Cir. 1978), *cert. granted sub nom. Bankers Trust Co. v. Mallis*, 431 U.S. 928, *cert. dismissed as improvidently granted sub nom. Banker's Trust Co. v. Mallis*, 435 U.S. 381.

105. See *supra* note 31 and accompanying text.

106. *Tomera v. Galt*, 511 F.2d 504 (7th Cir. 1975).

of collateral for bank loans" is an articulated, but often neglected, purpose of the 1934 Act.¹⁰⁷ In *Franklin National Bank v. Meadows*,¹⁰⁸ the court granted an implied right of action, in part, because of its specific concern with the manipulation of prices for securities pledged as collateral. The premise underlying this effect-oriented policy concern is that banks will be unduly placed in insecure positions as creditors as a sole result of borrowers' deceptive practices. This unwarranted result, as well as the general policy consideration described above, provides additional support to extending antifraud protection to pledges of stock under the 1934 Act.

CONCLUSION

The enumerated purpose of federal securities legislation is to promote full disclosure and provide remedies against persons who engage in fraud in connection with the purchase or sale of securities.¹⁰⁹ In order to achieve this objective, the courts have liberally construed the provisions contained in the Acts. A flexible reading of the definition of "sale" within the meaning of section 17(a) of the 1933 Act enabled the *Rubin* Court to extend antifraud protection to pledges of stock where it previously had been applied sporadically in the federal circuits. Although *Rubin* can be criticized as overstepping the intended coverage of the Acts, this criticism is quickly overcome when the investment risks and realities of pledgees, coupled with the overriding purposes of the Acts, are considered.

Thus, as a strong precedent, *Rubin's* section 17(a) holding lays the groundwork for application to its sister provision, section 10(b). A parallel reading of sections 17(a) and 10(b) with respect to pledges of stock resolves the controversy in the circuits. Furthermore, and most importantly, it is a step toward minimizing misunderstanding and inconsistency in the enforcement of federal securities laws.

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107. Section 2(3) of the 1934 Act, 15 U.S.C. § 78b(3) (1976).

108. 318 F. Supp. 1339 (E.D.N.Y. 1970).

109. See *supra* notes 26 & 27 and accompanying text.