

New Protection for Defrauded Pledgors of Securities Under the Federal Securities Laws: *Rubin v. United States*¹ — Section 17(a) of the Securities Act of 1933 (1933 Act)² prohibits deceptive practices “in the offer or sale of any securities.”³ Until the decision of the United States Supreme Court in *Rubin v. United States*,⁴ federal circuit courts of appeals⁵ had divided⁶ over whether a

¹ 449 U.S. 424 (1981).

² Section 17(a), 15 U.S.C. § 77q(a) (1976), provides in relevant part: It shall be unlawful for any person in the offer or sale of any securities . . . 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 any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The 1933 Act, 15 U.S.C. §§ 77a-77aa (1976), was proposed and enacted in an effort to control abuses in the securities markets which were believed to have been responsible in part for the collapse of the stock market in 1929. See L. LOSS, 1 SECURITIES REGULATIONS 127-30 (2d ed. 1961) [hereinafter cited as LOSS]

The Senate Report on the bill that ultimately became the Securities Act of 1933 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 to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.

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 timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REPORT NO. 47, 73d Cong., 1st Sess. 1 (1933) reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 17. 1 (J. Ellenberger and E. Mahar eds. 1973) [hereinafter cited as LEGISLATIVE HISTORY]. See generally *United States v. Naftalin*, 441 U.S. 768, 755-76 (1978) and *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1041 (7th Cir. 1979) (both cases discuss the legislative history of the 1933 Act).

For a thoughtful discussion of the various theories connecting the stock market crash of 1929 with abuses in the securities markets see generally FitzGibbon, *What is a Security? - A Redefinition Based on Eligibility To Participate In The Financial Markets*, 64 MINN. L. REV. 893, 912-18 (1980) [hereinafter cited as FitzGibbon].

³ 15 U.S.C. § 77q(a) (1976). See note 1 *supra* for the text of § 17(a). Section 17(a)'s prohibitions may not extend to sellers of securities. See *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970). 3 LOSS, *supra* note 2, at 1423-24.

⁴ 449 U.S. 424 (1981). See text and notes at notes 32-100 *infra* for discussion of case.

⁵ The first case addressing whether pledge transactions should be covered by the regulatory design established in the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976), was *SEC v. Guild Films Co.*, 279 F.2d 485, 489 (2d Cir.), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819 (1960).

⁶ Compare *United States v. Gentile*, 530 F.2d 461, 466-467 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976) (holding that a pledge is a sale) with *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1298-1300 (5th Cir. 1978) (holding that a pledge is not a sale).

pledge⁷ of stock as collateral security⁸ for a commercial loan constituted a "sale" of a security under section 17(a). The definitional provision of the 1933 Act, section 2(3),⁹ provides that, "[t]he term sale or sell shall include every contract of sale or disposition of a security or interest in a security, for value."¹⁰ The controversy surrounding the reach of section 17(a) had focused on whether this definition of "sale" encompassed pledge transactions.

The Second Circuit Court of Appeals was the only circuit court to conclude that fraud in connection with a pledge of securities violates section 17(a) of the 1933 Act.¹¹ The court held that the language of section 2(3) and the purpose of the 1933 Act required pledges to be treated as sales under the 1933 Act.¹² The court reasoned that nothing in the definition of sale in section 2(3) mandated the transfer of full title to a security before a sale is completed.¹³ To support this position, the court noted that the disjunctive phrase "disposition of a security *or* interest in a security, for value"¹⁴ in section 2(3) would be rendered meaningless if only transfers of full titles constituted sales.¹⁵ The court also observed that the primary purpose of the 1933 Act was to protect investors in securities from loss.¹⁶ It stated that one who accepts a pledge of stock

⁷ A pledge has been defined as "[a] bailment of goods to a creditor as security for some debt or engagement." BLACK'S LAW DICTIONARY 1038 (rev. 5th ed. 1979).

⁸ "The term 'collateral security' or 'collateral' means a pledge of incorporeal property assigned or transferred and delivered by a debtor or someone for him to a creditor as security for payment of a debt or the fulfillment of an obligation." L. JONES, A TREATISE ON THE LAW OF COLLATERAL SECURITIES AND PLEDGES, § 1, at 2 (3d ed. 1912) [hereinafter cited as JONES].

Hereinafter the technical term "collateral security" will be referred to as "collateral."

⁹ 15 U.S.C. § 77b(3) (1976). Section 2(3) provides in relevant part:

(3) 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 to sell," "offer for sale," or "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.

¹⁰ *Id.*

¹¹ *United States v. Gentile*, 530 F.2d 461, 466-67 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). Prior to *Gentile*, the Fifth Circuit Court of Appeals had addressed the issue of whether a pledge is a sale under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976). *McClure v. First Nat'l Bank*, 497 F.2d 490, 495-96 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). In addition, in *SEC v. Pig'N Whistle Corp.*, 359 F. Supp. 219 (N.D. Ill. 1973), the district court judge concluded with no explanation that a pledge is a sale under both § 17(a) and § 5(a) of the 1933 Act, 15 U.S.C. §§ 77q(a), 77e(a) (1976). *Id.* at 221. In *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819 (1960), the Second Circuit Court of Appeals held that a pledge was a sale under the 1933 Act. It did so in arriving at its conclusion that a pledgee is an underwriter of a security in some situations under § 2(11) of the 1933 Act, 15 U.S.C. § 77d(1) (1976), for the purposes of the Act's registration requirements, *Guild Films*, 279 F.2d at 489. *See* 15 U.S.C. § 77d(1) (1976). *See* note 19 *infra* for a more detailed discussion of *Guild Films*. Other cases resolved that a pledge is a sale under the 1933 Act as well but did so in a context other than § 17(a). *See, e.g.*, *SEC v. Dolnick*, 501 F.2d 1279, 1282 (7th Cir. 1974) (registration requirements); *SEC v. National Bankers Life Ins. Co.*, 334 F. Supp. 444, 456 (N.D. Tex. 1971) (registration requirements), *aff'd*, 447 F.2d 920, 921 (5th Cir. 1973).

¹² *United States v. Gentile*, 530 F.2d 461, 466 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 467.

¹⁶ *Id.*

as collateral for a commercial loan assumes the same risk of loss as does an investor.¹⁷ According to the court, such identical risk-taking requires equal protection under the Act.¹⁸ Therefore, the Second Circuit concluded that a pledge of stock is a "sale" within the meaning of section 2(3) and that pledges are protected under section 17(a) of the 1933 Act.¹⁹

Other courts addressing whether fraud connected with a pledge of securities violates section 17(a) of the 1933 Act were unconvinced that a pledge of stock as collateral for a commercial loan constituted a sale under the 1933 Act.²⁰ These courts relied on the statutory language²¹ and purposes²² of the 1933 Act to conclude that the transfer of a partial interest in a security in a pledge transaction does not constitute a sale.²³ The Fifth Circuit Court of Appeals, for example, held that the definitions of "offer" and "sale" in section 2(3) of the 1933 Act are not broad enough to encompass pledges of stock.²⁴ The court observed that Congress could have brought pledges within the definitions of sale under section 2(3) by including specific words to that effect.²⁵ The lack of any such specific language, the court reasoned, indicated that Congress did not intend to regulate pledge transactions.²⁶ The court also stated that the 1933 Act's policy of protecting investors from loss would not be served by treating pledges as sales.²⁷ The court viewed pledgees and investors as assuming dif-

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ In holding that a pledge is a sale under § 2(3) of the 1933 Act, the Second Circuit Court of Appeals relied on its earlier decision, *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819 (1960). At issue in *Guild Films* was whether a pledgee was a purchaser of a security under § 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1976). *Guild Films*, 279 F.2d at 489. Section 2(11) defines the term "underwriter" for the purposes of the 1933 Act. *See* 15 U.S.C. § 77b(11) (1976). The petitioners in the case were pledgees seeking to avoid the registration requirements of the 1933 Act by claiming that the acceptance of pledged stocks did not make one a purchaser of a security interest. *Guild Films*, 279 F.2d at 489. The court held that the petitioners could not "be exempted on the ground that they did not 'purchase' within the meaning of § 2(11)." *Id.* Thus, the term "sale" was understood by the court to include pledges and the term "purchaser," while not defined in the Act, was interpreted consistently with sale and held to include pledgees. *Id.* Although the court in *Guild Films* reasoned that a pledge is a sale, such a determination may not have been necessary to resolve the case. *See* 3 LOSS, *supra* note 2, at 649.

²⁰ *See* *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1044-45 (7th Cir. 1979); *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1298-1300 (5th Cir. 1978); *Rispo v. Spring Lake Mews, Inc.*, 485 F. Supp. 462, 466-68 (E.D. Pa. 1980).

²¹ *See, e.g.*, *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1300 (5th Cir. 1978); *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040-41 (7th Cir. 1979).

²² *See, e.g.*, *Lincoln Nat'l Bank v. Herber*, 604 F.2d at 1040-41.

²³ *See, e.g.*, *National Bank of Commerce*, 583 F.2d at 1298-1300.

²⁴ *National Bank of Commerce*, 583 F.2d at 1299-1300.

²⁵ *Id.* at 1300.

²⁶ *Id.* In *National Bank of Commerce*, the court was considering the 1933 Act coterminously with the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976), as the petitioner alleged claims arising under both Acts. *National Bank of Commerce*, 583 F.2d at 1297. *See* text and notes at notes 127-37 *infra* for a discussion of the court's treatment of the petitioner's claim under § 10(b) of the Securities Exchange Act of 1934. The court considered the policies of the two acts to be the same, *National Bank of Commerce*, 583 F.2d at 1297. It referred to these policies as the "meaning of the federal securities laws." *Id.* at 1300.

²⁷ *Id.*

ferent risks of loss, noting that pledgees have a principal loan note from the pledgor upon which they can sue if the value of the pledged securities is insufficient to satisfy the debt.²⁸ The court observed that investors have no such protection and thus assume a greater risk of loss than pledgees when entering a securities transaction.²⁹ The court concluded that the 1933 Act was designed to protect only investors in the public securities markets,³⁰ and that considering a privately negotiated pledge to be a "sale" under section 17(a) would be inappropriate.³¹

In *Rubin v. United States*,³² the United States Supreme Court resolved this dispute over whether a pledge of stock is an "offer or sale" of a security under section 17(a) of the 1933 Act.³³ In an opinion written by Chief Justice Burger, the Court held that a pledge does fall within the protective sweep of section 17(a), at least when the fraud in question pertains to the pledged securities themselves.³⁴ The Court did not reach the broader question of whether deceptive practices in such securities transactions which do not specifically relate to the value of the securities themselves violate section 17(a).³⁵ Ruling that under some circumstances the transfer of a partial interest in a security constitutes an "offer" or "sale,"³⁶ the Supreme Court held that a pledge transaction is one such circumstance in which full title to a security need not pass for an "offer" or "sale" to occur.³⁷

The defendant in *Rubin*, William Rubin, was the vice-president of a corporation experiencing financial difficulties.³⁸ Rubin approached Banker's Trust Company on behalf of the corporation in an effort to secure a five million dollar loan to remedy these problems.³⁹ Banker's Trust would not lend him the money without collateral and adequate information concerning the corpora-

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 1299-1300. In addition, the court in *National Bank of Commerce* focused on the fact that a pledge transaction does not alter the rights and privileges of the person holding title to a security in the same way as does a sale. *Id.* at 1300. The court observed that a pledgee has no "general property right" in the pledged stock, does not have normal shareholder rights, does not participate in the stock's appreciation and has no right to dispose of the stock. *Id.* The court viewed these limitations on the interest in a security transferred during a pledge transaction as significantly distinguishing a pledge of a security from a sale of a security. *Id.*

³² 449 U.S. 424 (1981).

³³ Although the Court stated that the pledges in question were "offers or sales," *id.* at 431 (emphasis added), the Court clearly considered a pledge to be a sale rather than an offer. When the Court described the pledge transaction, it used the language of § 2(3) which defines sales, not offers. *Id.* at 429. The Court stated: "Obtaining a loan secured by a pledge of shares of stock unmistakably involves a 'disposition of [an] interest in a security, for value.'" *Id.* (quoting § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1976)) (brackets added by Court). See note 9 *supra* for the definition of the term "sale" under the 1933 Act.

³⁴ 449 U.S. at 431.

³⁵ *Id.* at n.6.

³⁶ *Id.* at 429.

³⁷ *Id.* at 430.

³⁸ *Id.* at 425.

³⁹ *Id.*

tion's financial condition.⁴⁰ In preparing the corporation's financial statements and acquiring the collateral Banker's Trust requested, Rubin engaged in numerous fraudulent practices.⁴¹ With regard to the financial statements, the corporation's balance sheet listed a \$7,500,000 contract as an account receivable. This contract was nonexistent.⁴² The balance sheet also listed inflated figures for cash on hand and the worth of its mineral reserves.⁴³ Rubin's actions in acquiring the necessary collateral were equally deceptive. Tri-State pledged stock in six companies to Banker's Trust in exchange for a total of \$475,000 in loans.⁴⁴ The stocks were represented to Banker's Trust as being worth approximately \$1,700,000 when in fact they were almost worthless.⁴⁵ In addition, the securities were represented as "good, marketable, and unrestricted" when actually they were either issued by shell corporations, rented from the true owner for a fee solely for the purpose of misleading Banker's Trust or otherwise restricted.⁴⁶ Rubin served as the corporation's agent in most of these transactions.⁴⁷

Receiving an inquiry about Tri-State from the Justice Department shortly after consolidating all of Tri-State's loans into a single demand note, Banker's Trust demanded payment of the note.⁴⁸ When Tri-State did not pay⁴⁹ Banker's Trust sued on the note⁵⁰ and proceeded against Rubin personally as guarantor of the loans.⁵¹ Rubin signed a confession of judgment against himself for the full amount of the loan plus accrued interest but soon thereafter filed a petition in bankruptcy.⁵² Banker's Trust received only about one half of one percent of the face value of its loan.⁵³

The Justice Department learned of Rubin's fraudulent practices and indicted him for conspiring to violate federal statutes prohibiting fraud in connection with the sale of securities.⁵⁴ Rubin had a jury trial in the United States District Court for the Southern District of New York and was convicted.⁵⁵ He appealed the conviction on both evidentiary and statutory grounds.⁵⁶ His statutory claim was that a pledge of stock as collateral for a bank loan is not an

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 427 n.1. Rubin was also indicted for conspiring to commit fraud in the use of the mail and wire systems. *Id.*

⁵⁵ *Id.* at 428.

⁵⁶ *Id.*; *United States v. Rubin*, 609 F.2d 51, 57 (2d Cir. 1979), *aff'd*, 449 U.S. 424 (1981).

"offer" or "sale" of a security under section 17(a) of the 1933 Act and, therefore, his conviction for conspiring to violate that section of the securities act was wrong as a matter of law.⁵⁷ The Court of Appeals for the Second Circuit affirmed his conviction, dismissing his statutory argument without comment.⁵⁸ Rubin again appealed his conviction, maintaining that although he may have conspired to commit fraud in the pledge of securities,⁵⁹ he had not violated section 17(a) of the 1933 Act.⁶⁰ He claimed that a pledge of securities transfers to the pledgee only an implied right to dispose of the pledged securities in the event of subsequent loan default and foreclosure.⁶¹ Rubin contended that such a transfer was not an "offer or sale" of securities within the meaning of section 17(a). An "offer or sale," he argued, would occur only when Banker's Trust foreclosed on the pledged securities and thereby obtained full title to them.⁶²

The United States Supreme Court granted certiorari to consider Rubin's statutory claim.⁶³ The Court held that Rubin's pledge of stock as collateral for his bank loan was an "offer or sale" of a security under section 17(a).⁶⁴ Accordingly, the Court affirmed the judgment of the court of appeals.⁶⁵ The Supreme Court reasoned that protecting pledgees under section 17(a) was consistent with the language, legislative history and policies of the 1933 Act.⁶⁶

The Court began its analysis by examining the language of sections 2(3)⁶⁷ and 17(a)⁶⁸ of the 1933 Act.⁶⁹ The Court emphasized that section 2(3) defines the term "sale" to "include every contract of sale or *disposition* of a security or *interest in a security*, for value."⁷⁰ Similarly, the Court emphasized that section 2(3) provides that 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."⁷¹ The Court concluded that a pledge of stock as collateral for a loan "unmistakably involves a 'disposition of . . . [an] interest in a security for value.'" ⁷² The interest transferred by Rubin to Banker's Trust was described by the Court as having three important characteristics. First, the pledges antici-

⁵⁷ 449 U.S. at 428.

⁵⁸ *Id.* at n.5.; 609 F.2d at 66.

⁵⁹ 449 U.S. at 428.

⁶⁰ *Id.*

⁶¹ *Id.* at 428-29.

⁶² *Id.* at 429.

⁶³ *Rubin v. United States*, 445 U.S. 960 (1980).

⁶⁴ 449 U.S. at 430.

⁶⁵ *Id.* at 431.

⁶⁶ *Id.* at 428-31.

⁶⁷ See note 9 *supra* for the relevant text of § 2(3).

⁶⁸ See note 1 *supra* for the relevant text of § 17(a).

⁶⁹ 449 U.S. at 428-29.

⁷⁰ *Id.* at 429 (emphasis added by Court).

⁷¹ *Id.* (emphasis added by Court).

⁷² *Id.* (brackets added by Court).

pated a "self-executing procedure" (foreclosure) through which the pledgee, Banker's Trust, could obtain full title and ownership in the pledged securities if the pledgor, Tri-State, defaulted on its obligations.⁷³ Second, the self-executing procedure was to be exercised at the option of the pledgee.⁷⁴ Third, the pledgee had parted with valuable consideration when accepting the pledged securities.⁷⁵ The Court deemed the interest transferred to Banker's Trust through the pledges of securities as "inchoate but valuable."⁷⁶ Ruling that it is not "essential under the terms of the Act that full title pass to a transferee" for an offer or sale to occur under the 1933 Act,⁷⁷ the Court then concluded that the transfers of such inchoate interests in securities could constitute sales under the 1933 Act.⁷⁸

The Court seemed to view its examination of the specific statutory language of section 2(3) as the most important part of its analysis. The importance the Court attached to its textual analysis is evidenced by the Court's separation of this portion of its opinion from the remainder of its opinion by a new roman numeral heading.⁷⁹ In addition, the Court began the new section by stating: "when we find the terms of a statute unambiguous, judicial inquiry is complete, except in rare and exceptional circumstances."⁸⁰ The Court found no such circumstances present in *Rubin*.⁸¹ Nonetheless, the Court went on to analyze the legislative history and policies of the Act to support further its interpretation of the Act's language.⁸²

Focusing on the legislative history of the 1933 Act, the Court concluded that reading the term "sale" under section 2(3) to include pledges was entirely consistent with the history of the Act.⁸³ The Court recognized that the language

⁷³ *Id.* Full legal title to pledged securities does not pass in a pledge transaction and can only be obtained by a pledgee through a foreclosure action. JONES, *supra* note 8, § 4 at 7 & n.26.

⁷⁴ 449 U.S. at 429.

⁷⁵ *Id.* The Court did not indicate whether these characteristics are common to all pledge transactions or only the transactions between Tri-State and Banker's Trust. *Id.*

⁷⁶ *Id.* at 430.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* While the Court suggested that the language defining the term "sale" in the 1933 Act is unambiguous, *id.*, the meaning of the Court's assertion is unclear. One interpretation of the Court's suggestion is that the Court found that the definition of "sale" unambiguously covers pledge transactions. Another interpretation is that the term "sale" unambiguously embodies the broader principle that the transfer of a partial interest in a security is a sale. *Id.* The Court's examination of the legislative history and policies of the 1933 Act focused exclusively on pledge transactions. *Id.* This focus indicates that the Court found the definition of "sale" under the 1933 Act unambiguous in its inclusion of partial interests in securities transferred during the type of pledge transaction which occurred in *Rubin*. The holding in *Rubin*, therefore, may not apply to transfers of partial interests in securities occurring outside of a pledge context.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

Congress used to define "sale" in section 2(3) was almost identical to the language defining "sale" in a model "blue sky"⁸⁴ statute⁸⁵ which had been adopted by many states at the time the 1933 Act was passed.⁸⁶ A sale was defined under the model statute to "include every disposition, or attempt to dispose of a security or interest in a security for value."⁸⁷ The Court noted that one year before the passage of the 1933 Act, the Ninth Circuit Court of Appeals had held that the term "sale" under the model statute as adopted in California encompassed pledge transactions.⁸⁸ The petitioner in *Rubin*, the Court stated, had cited no authority to suggest that Congress had not incorporated the broad definition given to the term "sale" under the model statute when enacting section 2(3).⁸⁹ Therefore, the Court reasoned that it was consistent with the legislative history of section 2(3) to include pledges within the meaning of "sale" under that provision of the 1933 Act.⁹⁰

Not content to rest its holding solely on statutory language and legislative history, the *Rubin* Court extended its analysis of whether a pledge is a sale under sections 2(3) and 17(a) to consider the purposes behind the Act.⁹¹ The Court determined that including pledges under the section 2(3) definition of sale was consistent with the general purposes of the 1933 Act and the specific purposes of section 17(a).⁹² The purpose of the Act, the Court explained, was to "protect against fraud and promote the free flow of information in the public dissemination of securities."⁹³ In determining whether these purposes of the Act would be served by holding that a pledge constitutes a sale under section 17(a) the Court focused on two issues. First, it assessed the relative risk of loss assumed by purchasers of securities and by pledgees.⁹⁴ The Court observed that the economic considerations and circumstances taken into account by a direct investor are similar in "important respects" to the factors considered by a pledgee when deciding whether to accept securities as collateral for a loan.⁹⁵

⁸⁴ The term "blue sky law" is used to describe state securities regulation statutes and derives from the passage of the 1911 Kansas licensing statute. Supporters of the Kansas statute claimed that it was directed at "promoters who 'would sell building lots in the blue sky in fee simple,'" 1 LOSS, *supra* note 2, at 27 (quoting Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37, 37 (1916)).

⁸⁵ The model statute was the Uniform Sale of Securities Act, 449 U.S. at 430. The definition of sale in § 1(3) of the Act may be found in NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, HANDBOOK AND PROCEEDINGS 174 (1929) (Fourth and Final Draft) [hereinafter cited as NATIONAL CONFERENCE]. The Model Act was made obsolete by the passage of the 1933 Act. 1 LOSS, *supra* note 2, at 90.

⁸⁶ 449 U.S. at 430.

⁸⁷ NATIONAL CONFERENCE, *supra* note 85, at 174.

⁸⁸ 449 U.S. at 430. The decision was *Cecil B. DeMille Prods., Inc. v. Woolery*, 61 F.2d 45, 50 (9th Cir. 1932).

⁸⁹ 449 U.S. at 430. The Court's reasoning reflected the well-settled principle that Congress is presumed to have knowledge of the interpretation given existing law when incorporating it into new law. *Id.* To support its reasoning, the Court cited its decision in *Lorillard v. Pons*, 434 U.S. 575, 581 (1978), but did not discuss the above principle explicitly. *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

Both investors and pledgees, the Court suggested, risk a loss on their respective investments if the represented value of the securities in question is inflated.⁹⁶ Second, the Court considered whether the pledgee, like the investor, must rely on representations made by the transferor of the securities.⁹⁷ The Court indicated that a pledgee relies on the debtor's representations of the worth of securities in accepting them as collateral in the same way that a direct investor relies on his seller's representations.⁹⁸ The Court stressed that the transfer to a pledgee of a defeasible rather than a full interest in the pledged securities does not bear significantly on either the risk of loss assumed by a pledgee or the reliance a pledgee places on a pledgor's representations concerning the value of the pledged securities.⁹⁹ Deeming pledgees and direct investors similarly situated with regard to the purposes of the 1933 Act, the Court concluded that they should be accorded the same measure of protection under section 17(a).¹⁰⁰

Rubin resolved that pledgees are protected by section 17(a) of the 1933 Act.¹⁰¹ It remains unclear, however, whether pledgees can enforce section 17(a) through a private action for damages.¹⁰² If *Rubin* can be used to resolve a related issue arising under the Securities Exchange Act of 1934 (the 1934 Act), the absence of a private cause of action for damages under section 17(a) will not prevent defrauded pledgees from obtaining private relief from loss under the federal securities acts. Federal courts of appeals are divided¹⁰³ over whether a pledge of stock as collateral for a commercial loan is a sale of a security under the 1934 Act.¹⁰⁴ If a pledge of stock is deemed a "sale" under the 1934 Act, then defrauded pledgees logically should be considered "purchasers."¹⁰⁵ As

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.* While concurring in the opinion of the majority, Justice Blackmun stated that the Court simply should have held that a pledge is a "disposition" of a security within the meaning of § 2(3). He suggested that the Court should not have examined whether a pledge involves the transfer of an "interest in a security, for value." *Id.* at 432 (Blackmun, J., concurring). In so stating, Justice Blackmun seems to have been concerned that the Court may limit its characterization of a pledge as a sale to the 1933 Act and not extend it to the 1934 Act. Such a limitation of the *Rubin* holding might be reasonable if the two phrases "interest in a security" and "for value" contained in § 2(3) are determined to be the basis of the Court's holding. The definition of "sale" under the 1934 Act contains neither of these phrases. Section 3(a)(14) of the 1934 Act defines "sale" as including "any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1976). Justice Blackmun cited the language of the 1934 Act in his concurrence. 449 U.S. at 432 (Blackmun, J., concurring).

¹⁰¹ See text and notes at notes 32-108 *supra* for a discussion of *Rubin*.

¹⁰² Courts of appeals disagree over whether a private cause of action exists under section 17(a) of the 1933 Act: *Compare* Stephenson v. Calpine Conifers II, Ltd., 652 F.2d 808, 815 (9th Cir. 1981) (holding that a private cause of action exists under § 17(a)) and *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978) (holding that a private cause of action exists under § 17(a)) with *Shull v. Dain, Kalamn & Quail*, 561 F.2d 152, 159 (8th Cir. 1977) (holding that no private cause of action exists under § 17(a)).

¹⁰³ See text and notes at notes 110-54 *supra* for a discussion of the dispute concerning whether a pledge is a "sale" under the 1934 Act.

¹⁰⁴ Section 3(a)(14) of the 1934 Act, 15 U.S.C. § 78c(a)(14) (1976), defines "sale" for the purposes of the 1934 Act and provides in relevant part: "The terms 'sale' or 'sell' each include any contract to sell or otherwise dispose of." *Id.*

¹⁰⁵ In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme

purchasers, defrauded pledgees would have standing to bring a private action under section 10(b)¹⁰⁶ of the 1934 Act.¹⁰⁷ Therefore, if the language, legislative history and policies of the 1933 and 1934 Acts allow *Rubin's* holding under the 1933 Act to constitute authority for characterizing pledges as sales under the 1934 Act,¹⁰⁸ then defrauded pledgees should have a right of action for damages under section 10(b) of the 1934 Act.¹⁰⁹

This casenote will assess the impact of the holding in *Rubin* that a pledge of stock is a "sale" of a security under the 1933 Act on pledgee standing to sue under section 10(b) of the 1934 Act. Because the language, legislative history

Court held that a plaintiff must be either a purchaser or seller of securities to maintain a private action under § 10(b) of the 1934 Act. *Id.* at 730-31. The Court stated that this requirement was necessary to prevent the litigation of speculative claims filed primarily for settlement purposes, *id.* at 740, and based only on oral evidence, *id.* at 743. See text and notes at notes 214-50 *infra* for a complete discussion of the purchaser-seller requirement as it relates to pledge transactions.

¹⁰⁶ 15 U.S.C. § 78j(b) (1976). Section 10(b) provides in relevant part:

It shall be unlawful for any person, directly or indirectly, . . .

(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. The administrative ruling under which § 10(b) is enforced is Securities Exchange Commission rule 10b-5, 17 C.F.R. § 240.10b-5 (1981). This regulation provides in relevant part:

It shall be unlawful for any person, directly or indirectly, . . .

(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.

Id.

¹⁰⁷ It is well established that a private cause of action exists under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976). *Superintendent of Ins. v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). Nevertheless, the Court has never squarely held that such a cause of action exists. See Casenote, *A Scienier Requirement for SEC Injunctions Under Section 10(b) - Investor Protection Under the Securities Laws is Further Restricted*, Aaron v. SEC, 22 B.C.L. REV. 595, 595 n.7 (1981) [hereinafter cited as B.C. Casenote].

¹⁰⁸ The *Rubin* Court never mentioned the 1934 Act in its opinion. See 449 U.S. at 424-31. Justice Blackmun, however, did mention the 1934 Act and one case interpreting the Act in a pledge context. *Id.* at 432 (Blackmun, J., concurring). Notwithstanding the absence of any reference to the 1934 Act by the majority in *Rubin*, the Supreme Court in *Weaver v. Marine Bank*, 50 U.S.L.W. 4285, 4286 (Mar. 8, 1982), has suggested in a footnote that *Rubin* applies to both the 1933 and 1934 Acts. In *Weaver*, the Court observed that "[we] held in *Rubin v. United States* . . . that a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws." *Id.* at 4286 n.2. While the use of the term "laws" in this statement suggests that *Rubin* should extend beyond the 1933 Act, the Court provided no analysis to support its statement and did not recognize that the 1934 Act was not addressed or cited in *Rubin*. *Id.* The issue resolved by the Court in *Weaver* was whether a certificate of deposit is a security under the 1934 Act. *Id.* at 4286. The Court held that a certificate of deposit is not a security, *id.*, and did not directly address whether a pledge is a "sale" under the 1934 Act. *Id.* Therefore, the Court's footnote on *Rubin* is dicta. Nonetheless, the Court's mention of *Rubin* in the context of a 1934 Act case suggests that *Rubin* might be extended to the 1934 Act definition of "sale." See note 126 *infra* for the facts of *Weaver*.

¹⁰⁹ Comparisons between § 17(a) of the 1933 Act and § 10(b) of the 1934 Act are appropriate, particularly because § 17(a) has been interpreted to cover both initial issuances of securities and post-distribution transactions. See *United States v. Naftalin*, 441 U.S. 768, 778 (1979). Thus, the Court's determination in *Rubin* that a pledge is a sale under § 17(a) may not be

and policies of the two Acts are so similar, it is submitted that *Rubin* may be used to grant standing under section 10(b) to defrauded pledgees. The analysis leading to this conclusion follows several steps. First, the debate among the circuit courts preceeding *Rubin* regarding whether a pledge of stock should be considered a "sale" of a security under the 1934 Act will be outlined. Then, *Rubin*'s impact on the debate will be assessed. The statutory language of section 3(a)14 defining "sale" under the 1934 Act as well as the legislative history and policies of the 1934 Act will be considered in light of the *Rubin* Court's reasoning under the 1933 Act. This casenote demonstrates that the 1934 Act is sufficiently similar in all these aspects to the 1933 Act to require that pledges be considered sales under the 1934 Act after the Court's holding that pledges are sales under the 1933 Act. Next, it will be shown that if pledges are deemed to be "sales" under the 1934 Act, then pledgees should be deemed to be "purchasers." The soundness of this result will be measured by its logic and also by its consistency with the policies underlying the purchaser-seller standing requirement established by the Court in *Blue Chip Stamps v. Manor Drug Stores*. Finally, it will be suggested that if *Rubin* leads to expansion of the class of plaintiffs granted standing under section 10(b), then such expansion should be limited solely to defrauded parties to pledge transactions. Other holds of partial interests in securities should not be granted standing on the authority of *Rubin*.

I. RUBIN'S IMPACT ON PLEDGEE STANDING UNDER SECTION 10(b) OF THE 1934 ACT

Courts have contested¹¹⁰ and commentators have considered¹¹¹ whether a pledge of stock as collateral for a commercial loan is a sale of a security under

limited to situations where initial issuances are involved. Indeed, since the Supreme Court's decision in *Rubin*, two federal district courts have relied on the Court's interpretation of "sale" under the 1933 Act in holding that a private cause of action exists under § 10(b) of the 1934 Act for defrauded holders of a partial interest in a security. See *Oak Hill Cemetery, Inc. v. Tri-State Bank*, 513 F. Supp. 885, 892 (N.D. Ill. 1981) (holding that the acceptance of securities as collateral security on a note is a sale); *Paine, Webber, Jackson & Curtis, Inc. v. Conway*, 515 F. Supp. 202, 210 (N.D. Ala. 1981) (holding that a contract for the delivery of a security at a fixed price on a future date was a sale). See also *Weaver v. Marine Bank*, 50 U.S.L.W. 4285, 4286 n.2 (Mar. 8, 1982) (footnote suggesting that *Rubin* extends beyond the 1933 Act). See note 108 *supra* for discussion of *Weaver*.

¹¹⁰ Compare *Weaver v. Marine Bank*, 637 F.2d 157, 163-64 (3d Cir. 1980), *cert. granted*, 101 S.Ct. 3029 (1981), *rev'd on other grounds*, 50 U.S.L.W. 4285, 4286 (Mar. 8, 1982); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1028-30 (6th Cir. 1979); and *Mallis v. Federal Deposit Ins. Corp.*, 568 F.2d 824, 828-30 (2d Cir.), *cert. granted sub nom. Bankers Trust Co. v. Mallis*, 434 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978) (all holding that a pledge is a "sale" under the 1934 Act and that a pledgee is a "purchaser") with *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040-45 (7th Cir. 1979); and *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1298-1300 (5th Cir. 1978) (both holding that a pledge is not a sale under the 1934 Act and not reaching the issue of whether pledgees are purchasers).

¹¹¹ See Note, *A Pledge of Stock in a Commercial Loan: "Purchase or Sale" Under the Securities Exchange Act of 1934?*, 1979 ARIZ. ST. L.J. 669 (1979); Note, *Applicability of Rule 10b-5 to Pledges of Securities*, 68 CALIF. L. REV. 547 (1980); Case Comment, *Caveat Lender — Federal Securities Law Does Not Apply to A Commercial Loan Secured by a Pledge of Securities*, *Lincoln National Bank v. Herber*, 604 F.2d 1039 (7th Cir. 1979). 56 CHI-KENT L. REV. 1227 (1980); Case Comment, *Pledge of Securities as Loan Collateral Does Not Constitute a "Sale" as Required by Antifraud Provisions of the*

section 10(b) of the 1934 Act and rule 10b-5¹¹² thereunder. These issues have been the focus of the pledge debate under the securities laws because an individual must be either a purchaser or a seller of a security in order to have standing to bring a private action under section 10(b) of the 1934 Act and rule 10b-5.¹¹³ Thus, a pledgee cannot bring an action for fraud under section 10(b) unless pledgees are considered to be purchasers of securities. As a logical precondition to a pledgee being deemed a purchaser, a pledge of securities must be deemed to be a "sale"¹¹⁴ of securities. Five circuit courts of appeals have addressed these issues. The Second, Third, and Sixth Circuits have held that pledgees and pledge transactions are within the protective sweep of section 10(b) of the 1934 Act.¹¹⁵ The Fifth and Seventh Circuits, however, have held that section 10(b) does not encompass pledgees and pledge transactions.¹¹⁶ The courts have divided primarily on three grounds. First, they disagree over whether the language defining "sale" under the 1934 act is broad enough to encompass pledges. Second, they reach differing conclusions on whether pledgees assume the same risk of loss by accepting securities as collateral that investors do when investing in the public securities market. And finally, they perceive Congress' intent to regulate securities transactions outside of the public markets in passing the 1934 Act differently. *Rubin's* holding that a pledge is a "sale" under the 1933 Act helps to resolve these differences. First, the language defining "sale" under both Acts is very similar and *Rubin* suggests, therefore, that a pledge should be a "sale" under the 1934 Act. Second, the *Rubin* Court stated that pledgees and investors assume risks sufficiently similar to warrant similar protection. Third, *Rubin* did not directly address whether Congress intended to regulate transactions outside of the public securities markets. It will be shown, however, that other Supreme Court decisions have settled the question in favor of broadly construing the 1934 Act and that *Rubin* is simply consistent with them.

A. *Is a Pledge a Sale of a Security under the 1934 Act?*

1. The Background of Case Law

The reasoning of the Second Circuit Court of Appeals in *Mallis v. Federal Deposit Insurance Company*¹¹⁷ is representative of the circuit courts which held that a pledge is a sale under the 1934 Act.¹¹⁸ In *Mallis*, the Second Circuit held

Securities Act of 1933 and the Securities Exchange Act of 1934: Lincoln National Bank v. Herber, 604 F.2d 1039 (7th Cir. 1979), 11 CUM. L. REV. (1980).

¹¹² See note 106 *supra* for the text at § 10(b) and rule 10b-5.

¹¹³ In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court held that a plaintiff must be a purchaser or a seller of securities to maintain a private cause of action under § 10(b) of the 1934 Act. *Id.* at 730-31. See text and notes at notes 214-22 *infra* for a discussion of *Blue Chip*.

¹¹⁴ See note 104 *supra* for definition of "sale" under the 1934 Act.

¹¹⁵ See note 110 *supra* for citation to courts endorsing this position.

¹¹⁶ See *id.* for citation to courts endorsing this position.

¹¹⁷ 568 F.2d 824 (2d Cir.), *cert. granted sub nom. Bankers Trust Co. v. Mallis*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978).

¹¹⁸ See note 110 *supra* for cases following *Mallis*.

that a defrauded pledgee can bring a private action for damages under section 10(b).¹¹⁹ The court based its holding primarily upon earlier decisions under the 1933 Act in which the court had considered a pledge to be a "sale" of securities.¹²⁰ The court did not conduct a close textual analysis of the definition of "sale" in section 3(a)14 of the 1934 Act.¹²¹ Rather, it based its holding on the similar investment risks assumed by direct investors in securities and pledgees of securities.¹²² Pledgees were viewed as assuming an investment risk "identical" to that of investors insofar as they both expected the securities they accepted to have a continuing value.¹²³ The court recognized that the protection of individuals undertaking such investment risks is the "undisputable basis for statutory regulation of securities transactions."¹²⁴ The court concluded that there was no reason to treat transactions involving the same risks of loss differently and determined that a pledge is a sale under the 1934 Act.¹²⁵ The other courts which have held that a pledge is a "sale" under the 1934 Act have added little to the *Mallis* court's analysis of the issue.¹²⁶

¹¹⁹ 568 F.2d at 828-29.

¹²⁰ *Id.* at 829; see *United States v. Gentile*, 530 F.2d 461, 466-67 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976); see text and notes at notes 11-19 *supra* for a discussion of *Gentile*.

¹²¹ See note 104 *supra* for the text of § 3(a)14, 15 U.S.C. § 78c(a)(14) (1976).

¹²² 568 F.2d at 829. The court in *Mallis* quoted the language concerning the risk assumed by a pledgee directly from its earlier opinion in *Gentile*, 530 F.2d at 467. See text and notes at notes 11-19 *supra* for discussion of *Gentile*.

¹²³ 568 F.2d at 829.

¹²⁴ *Id.* (quoting *Gentile*, 530 F.2d at 467).

¹²⁵ *Id.*

¹²⁶ The Sixth Circuit Court of Appeals in *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) followed the holding in *Mallis*. *Id.* at 1029. The *Mansbach* court noted that a split of authority existed as to whether pledges were sales of securities under §§ 3(a)14 and 10(b) of the 1934 Act. *Id.* at 1028. The court summarized the arguments and authority on both sides of the issue, *id.* at 1028-29, and concluded, simply, that the reasoning which considered pledges to be sales was "better" than the reasoning that did not consider pledges to be sales. *Id.* at 1029. The court offered no independent analysis to explain why it preferred a reading of "sale" under the 1934 Act which included pledges to one that did not. *Id.* The *Mansbach* court did, however, draw a clear distinction between its holding and the holding in *Mallis*. *Id.* at 1030. The issue in *Mansbach* was whether a pledge of stock made to a securities broker-dealer as collateral for a securities transaction was a "sale" subject to the proscriptions of § 10(b). *Id.* at 1029. *Mallis*, in contrast, involved a pledge of stocks as collateral for a commercial bank loan. *Id.* at 1029. Without stating that pledges made to banks as collateral for commercial loans should not be sales under § 10(b), the *Mansbach* court stressed that it was not implicitly agreeing with *Mallis* that they should be considered sales. *Id.* Rather, the *Mansbach* court only held that a pledge is a sale under the 1934 Act when made to a securities broker-dealer as part of a securities transaction. *Id.*

In *Weaver v. Marine Bank*, 637 F.2d 157 (3d Cir. 1980), *cert. granted*, 101 S.Ct. 3029 (1981), *rev'd on other grounds*, 50 U.S.L.W. 4285, 4286 (Mar. 8, 1982), the Third Circuit Court of Appeals agreed with those courts holding a pledge of a security to be a sale of a security under the 1934 Act. *Id.* at 163. In *Weaver*, the court held that the pledge of a certificate of deposit as collateral for a bank loan was a sale of a security under the 1934 Act. *Id.* In so holding, the court considered fraudulent acts done in connection with this "sale" to be violations of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and therefore grounds for a private cause of action. *Id.* *Weaver*, however, differs from the other cases which have considered a pledge to be a sale under the 1934 Act in that the fraudulent acts in question were performed by the pledgee rather than the pledgor in the pledge transaction. *Id.* at 162-63. Yet, the court paid little notice to this distinction in relying on the reasoning of the cases which held a pledge to be a sale under § 10(b), when a pledgor performed fraudulent acts in the transfer of a security interest. *Id.* The court observed that "if a pledge is a purchase for the purpose of protecting a lender it is equally a sale for pur-

In *National Bank of Commerce of Dallas v. All American Assurance Co.*,¹²⁷ the Fifth Circuit Court of Appeals rejected the reasoning of the *Mallis* court and held that a pledge is not a "sale" under the 1934 Act.¹²⁸ The *National Bank of Commerce* court based its decision on the language of the statute¹²⁹ and on policy grounds.¹³⁰ The court observed that "sale" is defined in section 3(a)14 of the 1934 Act "to 'include any contract to sell or otherwise dispose of.'"¹³¹ The court reasoned that Congress' failure to include specific reference to pledges in this definition of sale indicated that it did not intend pledge transactions to fall within the Act's protective sweep.¹³² Moreover, the court rejected the policy argument that investors and pledgees assume identical risks of loss in accepting securities.¹³³ The court stressed that pledgees, unlike investors, have a claim on a loan note for which the securities were pledged as collateral if the value of the securities accepted proves to be less than anticipated.¹³⁴ Finally, the court observed that the securities laws were passed primarily to regulate the transfer of securities in the public market.¹³⁵ Accordingly, privately negotiated pledge transactions were perceived by the court to be beyond the parameters of the Act.¹³⁶ The court stated that such private transactions did not need federal protection.¹³⁷

In *Lincoln National Bank v. Herber*,¹³⁸ the Seventh Circuit Court of Appeals followed the Fifth Circuit's determination that pledges are not sales of securities under the 1934 Act.¹³⁹ The difference between the reasoning of the

poses of protecting the pledgor." *Id.* The court did not inquire into the legislative history or policies of the 1934 Act in arriving at its conclusion. *Id.* The court simply observed that it was inappropriate to presume that Congress "intended to exclude lending institutions extending credit on the security of pledged collateral" from the prohibitive sweep of § 10(b). *Id.*

¹²⁷ 583 F.2d 1295 (5th Cir. 1978).

¹²⁸ *Id.* at 1300.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* at 1298 n.4.

¹³² *Id.* at 1300.

¹³³ *Id.* After considering the argument that pledgees and investors undertake similar risks, the *National Bank of Commerce* court observed:

[T]his rationale might be a persuasive argument that the federal securities laws ought to encompass pledges, as well as purchases and sales. It does little to support a decision that they in fact do cover pledges. Congress can be presumed to know the difference between a collateral pledge transaction and a sale and purchase. If it had intended to cover both, it could easily have done so by words traditionally used to differentiate between the two.

Id.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* The Court also observed that a pledgee has no "general property right" in the pledged stock, does not have normal shareholder rights, does not participate in the stock's appreciation and has no right to dispose of the stock. *Id.* The court viewed these limitations on the interest in a security transferred during a pledge transaction as significant in distinguishing a pledge of securities from a more conventional sale of securities. *Id.*

¹³⁸ 604 F.2d 1038 (7th Cir. 1979).

¹³⁹ *Id.* at 1044.

court in *Lincoln National* and the reasoning of the Fifth Circuit in *National Bank* is that the *Lincoln National* court recognized that the language of section 3(a)14 of the 1934 Act defining "sale" was broad enough to encompass pledges.¹⁴⁰ The court, however, stated that reading the statute in a strict "literal" fashion to include pledges under the definition of "sale" would be inappropriate in light of section 3 of the 1934 Act.¹⁴¹ Section 3 provides that the statutory definition of terms under the Act governs the application of those terms "unless the context otherwise requires."¹⁴² In order to determine whether a "context over text"¹⁴³ approach to interpreting the Act was required, the court examined the legislative history of the 1934 Act and the economic realities of pledge transactions.¹⁴⁴ The legislative history of the Act, the court stated, showed that Congress was interested in controlling the flow of credit going into the public securities markets and was not concerned with the use of credit for other purposes.¹⁴⁵ According to the court, the transfer of a partial interest in a security to secure private credit has no bearing on the public securities markets and therefore is outside the ambit of the 1934 Act.¹⁴⁶

Turning to the "underlying economic realities" of pledge transactions, the *Lincoln National* court rejected the assertion that pledgees assume a risk identical to that of investors.¹⁴⁷ The court stated that pledgees assume a "commercial" risk rather than an "investment" risk.¹⁴⁸ The difference between these two types of risk, the court indicated, rests on the purpose for which they were assumed.¹⁴⁹ The court observed that a pledgee accepts securities for the purpose of securing a loan on which repayment is expected; an investor accepts securities for the purpose of realizing a return on the securities themselves and not on some other contractual arrangement.¹⁵⁰ Therefore, the court reasoned, a pledgee accepts only an "ordinary commercial risk incident to a loan transaction" and not the sort of risk that investors assume.¹⁵¹ An investor's risk is tied solely to whether the securities accepted continue to have value.¹⁵² Thus, the *Lincoln National* court concluded that a literal reading of "sale" under section 3(a)14 of the 1934 Act must be qualified by looking to the limited impact

¹⁴⁰ *Id.* at 1040. See note 104 *supra* for text of § 3(a)14.

¹⁴¹ *Id.* 15 U.S.C. § 78c(a) (1976).

¹⁴² *Id.* Section 2 of the 1933 Act, 15 U.S.C. § 77b (1976), contains an identical provision.

¹⁴³ 604 F.2d at 1041.

¹⁴⁴ *Id.* at 1040-44.

¹⁴⁵ *Id.* at 1042.

¹⁴⁶ *Id.* The court also noted that an original definition of "sale" in the 1934 Act did not refer to pledges even though it contained a comprehensive list of other transactions which were deemed to be sales. *Id.* See text and note at note 177 *infra* for the text of the original definition of sale.

¹⁴⁷ 604 F.2d at 1042.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

pledges have on the securities markets and the commercial rather than investment nature of pledge transactions.¹⁵³ To the court these qualifications constituted the necessary "context" for interpreting the term "sale" under the 1934 Act. The court held that this context required that pledges not be considered sales.¹⁵⁴

2. The Impact of *Rubin*

The issue of whether a pledge is a "sale" under the 1934 Act has been analyzed by the courts in terms of the statutory language, legislative history and general policies of the 1934 Act. The courts are divided over whether the absence of specific words including pledges under the section 3(a)14 definition of "sale" precludes the characterization of pledges as sales. In order to resolve this question, courts have inquired into the legislative history and general policies underlying the 1934 Act. In an effort to determine whether pledge transactions are the kind of transaction which Congress intended to regulate in passing the 1934 Act, the courts have focused on whether pledgees assume a risk of loss sufficiently similar to that assumed by investors to warrant the same protection. In addition, they have considered whether Congress only intended to regulate securities transactions affecting the public financial markets and, if so, whether pledge transactions affect those markets.

The Supreme Court's decision in *Rubin v. United States*¹⁵⁵ addresses the specific considerations and can help resolve the issue of whether a pledge constitutes a "sale" under section 3(a)14 of the 1934 Act. Courts addressing whether pledges are regulated by the 1933 or the 1934 Act have construed the Acts similarly. No court considering the pledge issue under either Securities Act has stated that the term "sale" be construed more broadly under one act than under another.¹⁵⁶ Since the term "sale" is treated uniformly under both

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 1044. The court did suggest that a foreclosure action by a pledgee after a pledgor's default on loan payments would be an action sufficient to characterize a pledge as a sale. *Id.*

¹⁵⁵ 449 U.S. 424 (1981).

¹⁵⁶ The 1933 and 1934 Acts have been tightly interwoven on the pledge issue. Both Acts were discussed as a unit in all of the circuit court cases addressing whether pledge transactions are protected under the 1934 Act. In *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978), the court observed that the definitions of "sale" under the two Acts are "functionally equivalent" and considered simultaneously the plaintiff's claims that a pledge is a "sale" of a security under the 1933 and 1934 Acts. *Id.* at 1298. Similarly, in *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038 (7th Cir. 1979), the court considered the plaintiff's claim that a pledge is covered by § 17(a) of the 1933 Act and § 10(b) of the 1934 Act at the same time. *Id.* at 1040. Further, most courts addressing the question of whether a pledge is a "sale" under one of the Acts either have relied in part on decisions under the other act, *see Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1039 (6th Cir. 1979) and *Mallis v. Federal Deposit Ins. Corp.*, 568 F.2d 834, 829 (2d Cir.), *cert. granted sub nom. Bankers Trust Co. v. Mallis*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978), or have referred to decisions under the other act, *see United States v. Gentile*, 530 F.2d 461, 467 n.6 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976) and *McClure v. First Nat'l Bank*, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 42 U.S. 930 (1975).

Because of this interlacing of the 1933 and 1934 Acts, the parties in *Rubin* made much

Acts in connection with pledges, *Rubin*'s holding, that the definition of "sale" under the 1933 Act¹⁵⁷ includes pledges, lends support to a similar reading of "sale" under the 1934 Act.¹⁵⁸ In addition, the *Rubin* Court's analysis of the legislative history of the term "sale" under the 1933 Act can assist in defining the scope of the term "sale" under the 1934 Act. Finally, the *Rubin* Court's discussion of the general policies of the 1933 Act provides important guidance in assessing whether the policies of the 1934 Act supports a construction of the term "sale" which includes pledges.

Following the methodology of the Court in *Rubin*, in order to determine whether a pledge constitutes a "sale" under the 1934 Act, the first step must be to examine the language of the Act itself.¹⁵⁹ Section 3(a)14¹⁶⁰ defines the term "sale" as used in the 1934 Act. It defines the term to "include any contract to sell or otherwise dispose of."¹⁶¹ This language is very similar to the language in the 1933 Act defining "sale" to "include every contract of sale or disposition of a security or interest in a security, for value."¹⁶² The difference between the provisions is that section 3(a)14 of the 1934 Act does not explicitly state that a "sale" includes a disposition of an "interest in a security."¹⁶³ Arguably, this difference in statutory language could indicate that Congress intended the term "sale" to have a broader meaning under the 1933 Act than under the 1934 Act.¹⁶⁴ A closer analysis of the language of section 3(a), however, rebuts this inference. First, the language defining "sale" in section 3(a)14 employs the word

reference to the 1934 Act in arguing their respective positions. See Petitioner's Brief for Certiorari at 8-10, 12, *Rubin v. United States*, 449 U.S. 424 (1981); Brief for Petitioner at 13, 21, 23-26, *Rubin v. United States* (1981); Brief for the United States, at 25, 40, *Rubin v. United States*, 449 U.S. 424 (1981).

¹⁵⁷ 449 U.S. at 429-31.

¹⁵⁸ The Supreme Court has suggested that where the language and legislative history of the two acts are similar it is appropriate to interpret the 1933 and 1934 Acts consistently. See *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967).

¹⁵⁹ 449 U.S. at 429. Chief Justice Burger began the Court's analysis in *Rubin* by stating: "We begin by looking to the language of the Act." *Id.* Focusing on statutory language in this way is a well-settled guiding principle for interpreting the securities acts. The principle reflects the Court's concern for not extending statutes beyond their intended parameters. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

¹⁶⁰ 15 U.S.C. § 78c(a)(14) (1976).

¹⁶¹ *Id.* See note 104 *supra* for text of provision.

¹⁶² 15 U.S.C. § 77b(3) (1976).

¹⁶³ Section 3(a)14 of the 1934 Act also does not require that the disposition in question be "for value," as does § 2(3) of the 1933 Act.

¹⁶⁴ Justice Blackmun seemed attentive to this problem. He stated in his concurrence to the majority opinion in *Rubin*:

The Court holds that a pledge confers an "interest in a security," and that therefore a pledge of shares of stock as collateral for a loan constitutes a 'disposition of [an] interest in a security, for value' within the meaning of § 2(3) of the Act, 15 U.S.C. § 77b(3). . . . I would hold simply that a pledge of stock as collateral is a type of 'disposition' within the meaning of section 2(3).

449 U.S. at 432. Justice Blackmun then cited language of the 1934 Act regarding "sale." *Id.* Justice Blackmun seemed concerned that the Court will focus on the absence of "interest in a security" in the 1934 Act definition of "sale" and later distinguish *Rubin* under the 1933 Act on this basis.

"includes" rather than "means" when setting the definition's parameters. Generally, when the word "include" is used rather than "means" in a definition, the definition is to be read broadly. Second, section 3(a) states that the definitions in the section are to be construed literally unless the "context" requires a different interpretation. There are at least three contexts which require qualification of the statute's literal language. This statutory language evidences congressional intent to provide a flexible rather than restrictive definition of the term "sale" under the 1934 Act.¹⁶⁵

The language of section 3(a)14 does not require that the term "sale" be construed narrowly. Section 3(a)14 states that "the terms 'sale' and 'sell' *include* any contract to sell or otherwise dispose of."¹⁶⁶ Congress' use of the word "include" in this definition is significant. Only five of the thirty-nine definitions prescribed under the definitional section of the 1934 Act contain the word "include."¹⁶⁷ All other terms are defined by the use of the word "means."¹⁶⁸ It is a principle of legislative drafting that the word "include," when used in a definition, suggests a partial definition of a term.¹⁶⁹ In contrast, when a definition uses a word "means" it generally indicates an exhaustive definition.¹⁷⁰ If this principle is applied to section 3(a)14 it would appear that the definition of "sale" under the 1934 Act is not limited to "any contract to sell or otherwise dispose of."¹⁷¹ Therefore, it would be appropriate to consider pledges "sales" under the 1934 Act even though the definition of "sale" in section 3(a)14 does not explicitly mention pledges.

The definitional section of the 1934 Act contains other language which also supports a broad reading of section 3(a)14. Section 3(a) of the Act states

¹⁶⁵ See text and notes at notes 66-71 *infra*.

¹⁶⁶ 15 U.S.C. § 78c(a)(14) (1976).

¹⁶⁷ 15 U.S.C. §§ 78c(a)(1) - c(a) (one of the other definitions is "purchase," § 3(a)13, 15 U.S.C. § 78c(a)(13) (1976)).

It should be noted that the state statute upon which the 1933 Act was modeled, the Uniform Sale of Securities Act *reprinted in* NATIONAL CONFERENCE, *supra* note 85, used the word "include" in setting out the definition of four of five terms defined in both the Model Act and the 1933 Act: "security," "person," "sale" and "dealer." Of these four terms, Congress used the word "include" only in the definition of "sale." While Congress based the 1933 Act in part on the Model Act, see text and notes at notes 90a-93 *supra*, the substitution of "means" for "include" by Congress in some definitions but not in others indicates an awareness of the different construction given the two words.

In *SEC v. National Securities, Inc.*, 393 U.S. 453 (1968), the Supreme Court noted the importance of the word "include" in the definition of "sale" under the 1934 and 1933 Acts when it observed:

"These sections [3(a)13 and 3(a)14] do indicate the breadth of the statutory terms "purchase" and "sale" by using the definitional word "include" and by including within the definitions contracts "to buy, purchase, or otherwise acquire" and "to sell or otherwise dispose of securities." *Id.* at 467 n.8; *accord*, *Lawrence v. SEC*, 398 F.2d 276, 280 at n.7 (1st Cir. 1968).

¹⁶⁸ See 15 U.S.C. § 78c(a)(1)-(35) (1976).

¹⁶⁹ See R. DICKERSON, *LEGISLATIVE DRAFTING* 93 (1954), *See also* 1 LOSS *supra* note 2, at 512 n.162.

¹⁷⁰ See R. DICKERSON, *LEGISLATIVE DRAFTING* 93 (1954).

¹⁷¹ Loss has gone so far as to suggest that the 1934 Act does not define "sale" at all except to the extent that "contracts to sell" transactions are clearly included in the notion of "sale." 2 LOSS, *supra* note 2, at 1097.

that the terms used in the chapter are to be construed as defined "unless the context otherwise requires."¹⁷² Section 3(a), however, does not indicate the factors relevant in determining the contexts that require other than strict application of the terms defined under the Act. One such context could be that section 3(a)14 uses "include" rather than "means" in its definition of sale. If the word "include" is viewed as a special context for interpreting the language defining "sale," then section 3(a) would also support a broad reading of "sale" under section 3(a)14 of the Act. Other possible contexts which would require a broad definition of "sale" would be decisions interpreting the same or similar provisions under other acts, the legislative history of the 1934 Act, and the general policies of the 1934 Act. Each of these "contexts" deserves separate consideration.

The definitions of "sale" under the 1933 and 1934 Acts generally are considered to cover the same transactions.¹⁷³ More specifically, in cases discussing pledge transactions, all courts of appeals have agreed that the term "sale" in the two acts should be construed in the same way.¹⁷⁴ Indeed, the definitions of the term under the two Acts have been deemed "functionally equivalent."¹⁷⁵ In *Rubin*, the Supreme Court held that a pledge is a "sale" of a security under the 1933 Act.¹⁷⁶ Because courts have considered the definitions of "sale" under both Acts to be the same, *Rubin* provides strong support for the proposition that pledges also are "sales" under the 1934 Act. Therefore, in the "context" of a Supreme Court decision interpreting a definition of sale similar to that contained in section 3(a)14 of the 1934 Act as including pledges, it is appropriate to consider a pledge to be a sale under section 3(a)14.

Another "context" which might qualify a literal interpretation of section 3(a)14 is the legislative history of the 1934 Act. Holding a pledge to be a sale under section 3(a)14 is consistent with this legislative history. One proposed version of the Securities Exchange Act provided that the term "sale" should "include any contract of sale or disposition of, contract to sell or dispose of, attempt or offer to dispose of, or solicitation of an offer to buy a security or interest therein."¹⁷⁷ This proposed definition of "sale," however, was not incorporated in full into the definition of "sale" which Congress passed in section 3(a)14 of the 1934 Act. As enacted, section 3(a)14 defines "sale" to include any contract to sell or otherwise dispose of."¹⁷⁸ Therefore, several changes were

¹⁷² 15 U.S.C. § 78c(a) (1976). See *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040-41 (7th Cir. 1979) (discussing contexts within which terms of the 1934 Act should be interpreted).

¹⁷³ See cases cited at note 156 *supra*.

¹⁷⁴ *Id.*

¹⁷⁵ *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1298 (5th Cir. 1978).

¹⁷⁶ 449 U.S. at 430.

¹⁷⁷ See H.R. 7852, 73d Cong., 2d Sess. (1934), reprinted in 10 LEGISLATIVE HISTORY, *supra* note 2 Item 24, §3(12) at 7.

¹⁷⁸ 15 U.S.C. § 78c(a)(14) (1976). This definition of "sale" was first proposed in H.R. 8720, 73d Cong., 2d Sess. (1934), reprinted in 10 LEGISLATIVE HISTORY, *supra* note 2, Item 28, § 3(15) at 9. Other proposed bills contained no specific definition of "sale." See H.R. 7924, 73d

made in the proposed definition to arrive at this final definition.¹⁷⁹ First, Congress deleted all reference to offers or solicitations of offers to sell. Second, the phrase "contract of sale or disposition of" was removed in favor of the phrase "contract to sell or dispose of." Third, the definition's specific statement that a sale included any disposition of "a security or interest therein" was deleted. Finally, Congress added the word "otherwise" to the phrase "contract to sell or dispose of." None of these changes evidences a congressional intent to exclude pledge transactions from the definition of "sale" under the 1934 Act. The third change is the most significant with regard to Congress' intended treatment of pledges under section 3(a)14.¹⁸⁰ It is arguable that by not including the phrase "a security or interest therein" in the definition of "sale" under section 3(a)14 of the 1934 Act, Congress intended to exclude transfers of partial interests in securities from the category "sale." There is little legislative history explaining why Congress did not include the phrase "a security or interest therein" as part of section 3(a)14.¹⁸¹ The records that do exist, however, indicate that Congress did not intend to exclude transfers of partial interests in securities from the category "sale" by choosing not to incorporate the phrase "a security or interest therein" from the proposed definition into section 3(a)14.¹⁸² Rather, Congress was concerned with making the definition of

Cong., 2d Sess. (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 2, Item 26, at 13-16; H.R. 8575, 73d Cong., 2d Sess. (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 2, Item 27 at 8-9.

¹⁷⁹ The following comparison of the differences between the definition of "sale" under the 1934 Act as proposed and as ultimately enacted is based strictly on a comparison of the language of the two definitions.

¹⁸⁰ The first change eliminates offers from the category "sale." A pledge, however, is considered to be a "sale," not an "offer," under the 1933 Act. See text and notes at 32-36 *supra*. The second change merely consolidates two equivalent phrases into one. The last change, adding the word "otherwise" to the phrase "dispose of," tends to enlarge the definition beyond the original narrower phrase "contract to sell or dispose of." Making the phrase read "contract to sell or otherwise dispose of" does not seem to limit the sorts of transactions the definition of "sale" was meant to encompass.

¹⁸¹ In *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038 (7th Cir. 1979) the Seventh Circuit Court of Appeals observed:

The definition of "sale" was not a topic to which much attention was devoted during the course of the hearings on the Acts, but considerable legislative effort was nevertheless expended in drafting the definition as evidenced by the length of the original definition, which was gradually pared down until it reached its present form.

Id. at 1042.

¹⁸² The first definition of "sale" was proposed by Mr. Rayburn to the House of Representatives on February 10, 1934 in H.R. 7852, 73d Cong., 2d Sess. (1934) *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 2, Item 24. See text and note at note 177 *supra*. Five weeks later, on March 19, 1934, the same Mr. Rayburn proposed the modified definition of "sale" which appears in § 3(a)14 as part of H.R. 8720, 73d Cong., 2d Sess. (1934) *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 2, Item 28. See text and note at note 178 *supra*. During the interval between Rayburn's introduction of the two proposed definitions of "sale," hearings on H.R. 7852, which was the bill containing the longer version of the definition, took place. See *Hearings Before the Interstate and Foreign Commerce Committee*, 73d Cong., 2d Sess., on H.R. 7852 and H.R. 8720, 8 LEGISLATIVE HISTORY, *supra* note 2, Item 23 [hereinafter cited as *Hearings*]. Only two statements were made during these hearings which may bear on why Rayburn submitted a new definition of "sale" in his second bill. First it was remarked that "the definitions, which

"sale" more succinct so that criminal sanctions under the Act would be more precisely construed.¹⁸³ There is no indication that Congress intended to change the quality of transactions covered under the proposed definition of "sale" when it made the definition more terse. Therefore, the fact that section 3(a)14 differs in significant ways from a proposed definition of "sale" under an early draft of the 1934 Act does not prohibit characterizing a pledge as a "sale" under the 1934 Act.¹⁸⁴

The legislative history of the 1933 Act adds further support to the position that Congress intended pledges to be considered sales under the 1934 Act. The Supreme Court has reasoned that since the same Congress passed the 1933 and 1934 Acts, the legislative history of one act can be used to interpret similar sections of the other Act.¹⁸⁵ Applying this principle of statutory analysis, the legislative history of the term "sale" under section 2(3) of the 1933 Act¹⁸⁶ can

are . . . broad and general, should be made more definite and specific. . . . " *Id.* at 154. This statement related to all of the definitions of "sale" as a general statement suggesting a change in the form of the definition but not the substance. Second, it was observed that the language in the proposed definition of "sale" referring to "an attempt or offer to dispose" might "make a mere conversation have the same legal effect as the action resulting from [a] conversation." *Id.* at 493. This statement addresses whether offers should be considered sales and not whether transfers of partial interests in securities should be considered sales. The statement does not bear on the latter issue. Therefore, to the extent that Rayburn and the Congress were moved by the hearings on H.R. 7852 to limit the definition of "sale" contained therein, the legislative history shows no intention to eliminate transfers of partial interests in securities from the category "sale."

¹⁸³ See *Hearings*, *supra* note 182, at 154 for statement raising concern regarding criminal prosecutions.

¹⁸⁴ Logic supports this position. It could be argued that the absence of the phrase "interest therein" in § 3(a)14 evidences congressional intent not to include transfers of partial interest in securities under the definition "sale." If this argument is accepted, however, one also would have to accept that Congress intended to remove all transactions in securities from the category "sale" since Congress did not explicitly use the word "security" in defining "sale" under § 3(a)14. It is unlikely that Congress intended the definition of "sale" under the Securities Exchange Act not to include securities transactions. It is equally unlikely, therefore, that absence of the words "interest therein" reflects an intent to exclude transfers of partial interests in securities from the category "sale."

Some support for the proposition that Congress' failure specifically to mention partial interests in securities as part of the language of a section in the securities acts does not indicate congressional intent to exclude such interests from the section can be derived from the 1933 Act. Section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1976), has been construed to cover pledge transactions even though specific mention of pledges was dropped from the language of the statute as ultimately enacted. See *SEC v. Guild Films*, 279 F.2d 485, 489 (2d Cir.), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819 (1960). In *Guild Films*, the Second Circuit Court of Appeals focused on the legislative history of the 1933 Act concerning which transactions were to be exempted from the Act's registration requirements to support the proposition that a pledge should be considered a sale under the 1933 Act. *Id.* at 489. The court focused on a proposed provision of the Act which would have exempted from the Act's registration requirements transactions made in an effort to liquidate bona fide debts under a pledge contract. *Id.* See H.R. 4314, 73d Cong., 1st Sess. §12(b) (1933), *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 2, Item 22, at 22. The court noted that Congress had rejected the proposed provision. 279 F.2d at 489. The court appeared to consider Congress' rejection of this provision as an implied inclusion of pledges under the Act's regulation and protection. See *id.*

¹⁸⁵ *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967).

¹⁸⁶ See *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1042 & n.5 (1979) for an analysis of the 1934 Act in light of the legislative history of the 1933 Act. See note 9 *supra* for the text of

be used to interpret the term "sale" under section 3(a)14 of the 1934 Act. In describing the definition of "sale" in the 1933 Act, one of the drafters of the Act stated that the term had been taken from the Uniform Sales of Securities Act "as nearly as we could draft it."¹⁸⁷ The *Rubin* Court pointed out that under the Uniform Sales of Securities Act pledges were characterized as sales and concluded that Congress intended to include pledges under the 1933 Act definition of sale.¹⁸⁸ Following *Rubin*, one would have to conclude that Congress also intended to include pledges in its definition of "sale" under the 1934 Act. This conclusion is supported by the absence of any statements in the legislative history of the 1934 Act suggesting that the term "sale" under the two acts was intended to cover different transactions.¹⁸⁹ It would seem that if Congress had intended to make such an important distinction between the 1933 and 1934 Acts it would have said so.

In addition to being consistent with the language of section 3(a)14 and the legislative history of 1934 Act, holding a pledge transaction to be a "sale" under section 3(a)14 is supported by the "context" of the policies underlying the 1934 Act. Courts which have considered the propriety of characterizing pledges as sales and thereby extending the proscriptions against fraud in section 10(b) to pledge transactions have focused primarily on two policy issues. An initial concern has been whether Congress intended the 1934 Act to cover the transfer of partial interests in securities occurring in privately negotiated transactions.¹⁹⁰ In addition, the courts have assessed whether pledgees assume investment risks sufficiently similar to those assumed by direct investors to warrant their protections under the 1934 Act.¹⁹¹

Some courts have asserted that a privately negotiated pledge should not be considered a "sale" of a security because the 1934 Act only relates to transactions impacting the public securities markets.¹⁹² Limiting the regulatory sweep of the 1934 Act to such transactions unduly restricts the policy focus of the 1934 Act. While securities acts were directed primarily towards securities transactions in the public financial markets,¹⁹³ the acts were concerned with other

section 2(3), 15 U.S.C. § 77b(3) (1976), which defines "sale" under the 1933 Act.

¹⁸⁷ See *The Securities Act of 1933: Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 76 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 2, Item 21, at 76.

¹⁸⁸ 449 U.S. at 430.

¹⁸⁹ See S. REP. NO. 792, 73d Cong., 2d Sess. (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 2, Item 17, at 14; H.R. REP. NO. 1383, 73d Cong. 2d Sess. (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 2, Item 18, at 17. When the reports discuss significant changes made in the definitions of the 1934 Act no mention is made of the "sale."

¹⁹⁰ See, e.g., *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1042 (7th Cir. 1979); *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1300 (5th Cir. 1978).

¹⁹¹ See, e.g., *Lincoln National Bank v. Herber*, 604 F.2d 1038, 1042-43 (7th Cir. 1979); *Mallis v. Federal Deposit Ins. Corp.*, 568 F.2d 824, 828-30 (2d Cir.) cert. granted sub nom. *Bankers Trust Co. v. Mallis*, 434 U.S. 928 (1977), cert. dismissed as improvidently granted, 435 U.S. 381, 388 (1978).

¹⁹² See text and notes at notes 133-37, 145-46 *supra*.

¹⁹³ See *FitzGibbon*, *supra* note 2, at 913. See also 15 U.S.C. § 78b (1976) regarding the necessity of securities regulations in the public financial markets.

securities as well.¹⁹⁴ The broad scope of the 1934 Act is exemplified by section 10(b). That provision prohibits fraud or misrepresentation in connection with the purchase or sale of securities which are registered on a national exchange *and* in the purchase or sale of securities not so registered.¹⁹⁵ Indeed, the Supreme Court has indicated that the purpose of section 10(b) is not confined to preserving the integrity of the public securities markets.¹⁹⁶ The Court has observed that in section 10(b) "Congress meant to bar devices and contrivances in the purchase or sale of securities whether conducted in organized markets or face to face."¹⁹⁷ Loss can result from fraudulent acts not connected with transactions in the public markets. It would be unduly restrictive to interpret section 10(b) as covering only transactions directly affecting the public financial markets. Section 10(b) indicates that Congress was interested in preventing fraud in securities transactions as well as preserving the integrity of the public securities markets generally.¹⁹⁸ Therefore, whether pledge transactions affect the public securities markets is not dispositive of whether the policies of the 1934 Act are consistent with characterizing a pledge as a sale. Rather, prohibiting fraud in securities transactions, whether those transactions are conducted in the public market or privately, is an equally important policy consideration of the 1934 Act. This policy of fraud prevention would be fostered by considering a pledge of securities to be a "sale" under section 3(a)14.¹⁹⁹

Since the impact of pledges on the public securities markets will not determine whether the policies of the 1934 Act support construing the term "sale" to include pledges, other policy considerations must be assessed. The only other main policy of the 1934 Act considered by the courts addressing whether a pledge should be a sale under the 1934 Act concerns risk of loss. Courts focus

¹⁹⁴ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 728 (1975). In *Blue Chip*, the Court observed that "the Securities Exchange Act of 1934 was described as an Act to provide for the regulation of securities exchanges of over-the-counter markets operating in interstate commerce . . . to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes." (citations omitted) (emphasis added).

¹⁹⁵ 15 U.S.C. § 78j(b) (1976). See note 106 *supra* for text of §10(b).

¹⁹⁶ See *United States v. Naftalin*, 441 U.S. 768, 775 (1979). In *Naftalin*, the Court admonished: "prevention of frauds against investors was surely a key part of [the securities laws], but so was the effort 'to achieve a high standard of business ethics . . . in every facet of the securities industry.'" *Id.* (quoting *SEC v. Capital Gains Bureau*, 375 U.S. 186, 186-87(1963)) (emphasis added by the *Naftalin* Court).

¹⁹⁷ *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). Extending § 10(b) beyond the securities markets is consistent with the policy of interpreting the 1934 Act flexibly while remaining consistent with congressional intent. See *Goldberg v. Meridor*, 567 F.2d 209, 215 (2d Cir. 1977); *Harrison v. Equitable Life Assurance Society of the United States*, 435 F. Supp. 281, 285 (W.D. Mich. 1977). See also *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (by implication).

¹⁹⁸ Section 10(b), 15 U.S.C. § 78j(b) (1976), states only that it shall be unlawful for a person to engage in deceptive practices "in connection with the purchase or sale of *any* security" (emphasis added). The provision imposes no requirement that the sale of the securities be conducted in the public markets or that it not be privately negotiated.

¹⁹⁹ That the 1934 Act includes §10(b) as a general fraud provision evidences that fraud prevention is a major focus of the 1934 Act.

on the similarity between the risk of loss assumed by a pledgee in accepting securities and that of an investor accepting securities for consideration.²⁰⁰ There is little question that one of the primary purposes of the 1934 Act was to provide protection for investors in securities.²⁰¹ If pledgees assume a risk of loss similar to that of investors, however, it is reasonable to extend to them the same protections under the Act that investors enjoy. In *Rubin*, the Supreme Court observed that the risk assumed by a pledgee in a pledge transaction is "similar in important respect[s] to the risk an investor undertakes when purchasing shares."²⁰² Based on this reasoning, the Court held that pledgees warrant the same protection under the 1933 Act as do investors.²⁰³ The nature of the risk assumed by pledgees of securities and investors in securities inheres in the transactions themselves and exists whether or not the transactions are regulated by the securities laws. Therefore, *Rubin's* holding that pledgees deserve the same protection under the 1933 Act as do investors suggests that pledgees and investors should be treated similarly under the 1934 Act as well.²⁰⁴ Following *Rubin*, it is appropriate to view the "context" of providing investor protection as supporting the characterization of pledges as "sales" under the 1934 Act.

A third policy concern not mentioned by courts considering whether pledges are "sales" under the 1934 Act provides additional support for concluding that pledges should be considered "sales." The securities acts were passed in an effort to restore the confidence of investors in securities which had been lost during the 1929 stock market crash.²⁰⁵ By restoring investor confidence in securities, Congress hoped to encourage the flow of money and thereby strengthen the economy.²⁰⁶ Protecting pledgees under the 1934 Act by considering pledges to be "sales" would foster the confidence of lending institutions in pledged securities and encourage the flow of money through the economy. Therefore, the policy of encouraging the flow of money through the economy would be served by treating pledges as sales under the 1934 Act. For example, a small "honest business"²⁰⁷ may need to raise capital through a

²⁰⁰ See text and notes at notes 121-25 and 132-36 *supra* for cases discussing risk of loss.

²⁰¹ See note 2 *supra*.

²⁰² 449 U.S. 424, 431 (1981).

²⁰³ *Id.*

²⁰⁴ It could be argued that this risk analysis under § 17(a) is not applicable to § 10(b) of the 1934 Act because the 1933 Act covers the initial issuances of securities while the 1934 Act covers post-issuance transactions. Therefore, the two Acts apply to different transactions. See 1 LOSS, *supra* note 2, at 130. This argument is weak because any distinction which may exist between the scope of § 17(a) of the 1933 Act and § 10(b) of the 1934 Act on this basis is negated by the Supreme Court's holding that § 17(a) covers fraudulent actions both during the initial issuance and later trading of securities. *United States v. Naftalin*, 441 U.S. 768, 778 (1979).

²⁰⁵ See 15 U.S.C. § 78(b) (1976). It has been suggested that the impact of the 1929 stock market crash was heightened by the reluctance of investors to buy securities after losing confidence in them during the initial crash. See FitzGibbon, *supra* note 2, at 916. See generally Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553, 662-75 (1974).

²⁰⁶ See note 2 *supra* for a statement of general policies behind 1933 Act.

²⁰⁷ *Id.*

bank loan. If securities constitute part of the collateral the business pledges for the loan it is essential that the bank have confidence that the securities actually have the value which the pledgor claims. As the *Rubin* Court observed, the bank as pledgee assumes the same risk that the securities it receives will be worth less than expected as does a direct investor.²⁰⁸ Federal regulation of pledge transactions under the 1934 Act would encourage pledgees to have confidence in the represented value of pledged securities in the same way that it encourages investors to have confidence in purchased securities. The greater the bank's confidence that the purported value of the securities which the honest business pledges as collateral for a loan represents their full value, the more willing the bank will be to make the loan. By making the loan the bank would help to increase the flow of money through the economy.²⁰⁹ Therefore, building the confidence of lending institutions in pledged securities by considering pledges to be "sales" would promote the 1934 Act's policy of encouraging the flow of investment capital through the economy.

In conclusion, the absence of any specific reference to pledges in the 1934 Act's statutory definition of "sale" does not preclude characterizing a pledge as a sale. By using "includes" rather than "means" in its definition of "sale," Congress evidenced an intent to bring more transactions under the category "sale" than the definition explicitly provided.²¹⁰ In addition, the "context over text" requirement of section 3(a) lends further support for a reading of "sale" which is not confined to the explicit language of the statutory definition. In light of *Rubin*, the context over text approach to defining "sale" strongly supports characterizing pledges as sales under the 1934 Act. The "contexts" of statutory language, legislative history and general policies of the 1934 Act all support following *Rubin*'s holding that a pledge is a sale under the 1933 Act and considering pledges "sales" under the 1934 Act. Therefore, the broad scope of the term "sale under the 1934 Act provided by Congress in the statutory language of sections 3(a)14 and 3(a) of the Act suggests that pledges should be considered sales after *Rubin*.

Characterizing pledges as "sales" under the 1934 Act, however, does not

²⁰⁸ See text and notes at notes 94-98 *supra* for a summary of *Rubin*'s treatment of the relative risks assumed by pledges and investors.

²⁰⁹ The Supreme Court has used similar analysis in holding brokers of securities protected under § 17(a) of the 1933 Act. *United States v. Naftalin*, 441 U.S. 768, 773-77 (1979). In *Naftalin* the Court observed that "the welfare of investors and financial intermediaries are inextricably linked — frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole." *Id.* at 776.

²¹⁰ Construing the term "sale" in this fashion is consistent with the general policy of encouraging flexibility in the application of the securities acts. See *United States v. Naftalin*, 441 U.S. 768, 773 (1979); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). This flexibility theme, however, must be tempered by the recent trend in Supreme Court decisions to strictly construe access to private actions under § 10(b) of the 1934 Act. See note 216 *infra*. A strict textual approach to defining the scope of the term "sale" under the 1934 Act might lead the Court to look beyond the functionally equivalent nature of the term under the 1933 and 1934 Acts, see *National Bank of Commerce v. All Am.*

end the inquiry into whether pledgees of stock have a private cause of action for damages under section 10(b) of the 1934 Act. Section 10(b) prohibits deceptive practices in connection with the purchase or sale of securities²¹¹ and courts have implied a private right of action for losses resulting from such practices.²¹² That losses have resulted from deception in connection with the sale of a security, however, is only the first step in bringing a private action under section 10(b). In addition, the party bringing the action must be deemed to be a *purchaser* of a security.²¹³ Therefore, even though a pledge may be deemed a "sale" under the 1934 Act, a pledgee cannot bring a private action under section 10(b) unless pledgees are considered to be "purchasers" of securities.

B. *Is a Pledgee a Purchaser of Securities Under Section 10(b)?*

The 1934 Act does not explicitly grant a private cause of action to individuals aggrieved by fraudulent practices which violate section 10(b).²¹⁴ Rather, courts have implied a private cause of action to enforce the prohibitions of the provision.²¹⁵ In recent years, however, the Supreme Court has limited the class of plaintiffs who can sue under section 10(b) by impressing restrictions on the sort claims which can be brought under section 10(b).²¹⁶ One such restriction is a standing requirement that a plaintiff suing under section 10(b) must be either a purchaser or seller of securities.²¹⁷ As explained by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*,²¹⁸ the primary purpose of the restriction is to prevent vexatious litigation based on speculative claims of loss filed in some instances only for harassment purposes.²¹⁹ The *Blue*

Assurance Co., 583 F.2d 1295, 1298 (5th Cir. 1978), and hold that the absence of specific language in the 1934 Act characterizing the disposition of an interest in a security as a sale mandates that pledge transactions not be considered sales.

²¹¹ See note 106 *supra* for the text of § 10(b).

²¹² *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971); *Wachovia Bank and Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 353 (D.C. Cir. 1980).

²¹³ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975). See also *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 462-64 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (first court to establish purchaser-seller requirement).

²¹⁴ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

²¹⁵ *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946). *Kardon* was the first case to establish a private right of action under § 10(b). See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). In *Kardon*, the court focused on the Restatement of Torts § 286 (1934), which states that an individual is liable for tortious conduct if s/he violates a legislative enactment prohibiting actions which would injure a specific class of individuals which the statute sought to protect. 69 F. Supp. at 513. See generally B.C. Casenote, *supra* note 107, at 595 n.7 (summary of cases establishing private action under § 10(b)).

²¹⁶ The Supreme Court has restricted standing to sue under § 10(b) in three ways. First, § 10(b) does not govern claims of corporate mismanagement, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 426, 477 (1977); second, proof of scienter is required to find a § 10(b) violation, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976); third, a plaintiff must be an actual purchaser or seller of securities to bring an action under § 10(b), *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

²¹⁷ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

²¹⁸ *Id.*

²¹⁹ *Id.* at 740-41. The *Blue Chip* Court was concerned about plaintiffs filing "strike" suits. *Id.* at 740. The Court described such suits as claims filed simply for the sake of harassing a

Chip Court indicated that Congress did not intend to extend a private cause of action to all "bystanders"²²⁰ to the securities markets when it passed section 10(b) and tried to restrict the class of 10(b) plaintiffs to those who actually participate in securities transactions.²²¹

While the *Blue Chip* Court resolved that only "actual purchasers and sellers of securities" can sue under section 10(b) of the 1934 Act,²²² the Court failed to define the terms "purchasers" and "sellers" with any precision.²²³ Thus, it has remained unclear after *Blue Chip* whether a person defrauded in connection with the transfer of a partial interest in a security meets the purchaser-seller standing requirement.²²⁴ Equally unresolved is the more

defendant into settling a frivolous claim because the inconvenience of the suit to the defendant, in terms of time and money, would outweigh the advantage of winning in protracted litigation. *Id.* at 740-41. The Court viewed such claims as unfair to unwary and innocent defendants. *Id.*

²²⁰ *Id.* at 733, 752-54. The Court indicated that Congress did not intend to protect bystanders to the securities market, such as non-purchasing offerees. *Id.*

²²¹ *Id.* at 747, 752-55. The plaintiff in *Blue Chip* was an offeree of a stock offering made pursuant to an antitrust decree. *Id.* at 725. The plaintiff alleged that it did not purchase the offered stock due to the offeror's prospectus which "was materially misleading in its overly pessimistic appraisal of Blue Chip's status and future prospects." *Id.* at 726. The Supreme Court held that the plaintiff had no standing to sue because private actions under § 10(b) are limited to actual "purchasers and sellers" of securities and do not encompass frustrated offerees. *Id.* at 730-31. In holding that plaintiffs must be purchasers or sellers of securities to bring a private action under § 10(b), the Court resolved a dispute among the circuit courts of appeals. The "purchaser-seller" requirement was first articulated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). At the time that *Blue Chip* was decided the requirement had been widely accepted. *Blue Chip*, 421 U.S. at 731. In *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 659-60 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), however, the Seventh Circuit Court of Appeals rejected the purchaser-seller requirement. *Id.* at 660. Moreover, prior to *Blue Chip*, many courts had avoided adhering strictly to the purchaser-seller requirement in certain situations. *See, e.g.*, *James v. Gerber Products Co.*, 483 F.2d 944, 948 (6th Cir. 1973) (beneficiary of trust); *Coffee v. Permian Corp.*, 434 F.2d 383, 386 (5th Cir. 1970), *cert. denied*, 412 U.S. 920 (1973) (forced seller exception); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 212 (2d Cir. 1968) (derivative shareholder suits where the corporation is a purchaser or seller of securities); *Mutual Shares Corp. v. Genesco*, 384 F.2d 540, 546-47 (2d Cir. 1967) (actions seeking injunctive relief); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396 (2d Cir. 1967) (defrauded broker suing client who refused to pay for ordered stock); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 206-207 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (trustee in bankruptcy). For articles discussing the ambiguity of the purchaser-seller requirement prior to *Blue Chip*, see generally *Boone & McGowan, Standing To Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); *Kellog, The Inability to Obtain Analytic Precision Where Standing to Sue Under Rule 10b-5 is Involved*, 20 BUFFALO L. REV. 93 (1970); *Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). See also authorities cited in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 721, 768-69 n.3 (1975).

²²² *Blue Chip*, 421 U.S. at 730.

²²³ See generally *Gallagher, 10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 DICK. L. REV. 1, 36-40 (1975); Note, *Blue Chip Stamps v. Manor Drug Stores: Failure to Solve the Purchaser-Seller Problem*, 70 NW. U.L. REV. 965 (1976); Note, *Blue Chip Stamps v. Manor Drug Stores: Perpetuation of a Loophole in Rule 10b-5 Protection*, 8 SW. U.L. REV. 706 (1976). Some of the old exceptions to the purchaser-seller requirement have resurfaced since *Blue Chip* on the principle that they are consistent with the *Blue Chip* policies: *Alley v. Miramon*, 614 F.2d 1372, 1386 (5th Cir. 1980) (forced seller exception); *Fuchs v. Swanton Corp.*, 482 F. Supp. 83, 89 (S.D.N.Y. 1979) (injunctive relief); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977) (beneficiary of trust); *Weitzman v. Stein*, 436 F. Supp. 895, 901-02 (S.D.N.Y. 1977) (purchase by broker for client).

²²⁴ *Blue Chip*, 421 U.S. at 730-31. See *McCloskey v. McCloskey*, 450 F. Supp. 991, 994

specific question of whether pledgees should be considered "purchasers" and granted standing to sue under section 10(b). Once a pledge of securities is deemed to be a "sale" under the 1934 Act, however, pledgees should be deemed to be purchasers. First, case law uniformly supports construing the term "purchaser" to include pledgees once pledges are deemed to be "sales." No case addressing the issue has held otherwise. Second, the statutory language of the 1934 Act supports the same conclusion. The definition of "purchase," and by implication "purchaser," under the 1934 Act is so much like the definition of "sale" under the Act that "purchaser" and "sale" should be read in a complementary fashion. And finally, the *Blue Chip* policy of discouraging vexatious litigation is fostered by characterizing pledgees as purchasers under the 1934 Act. Pledgees are parties to contracts on the basis of which loss from fraud can be determined. Therefore, the claims they bring will not be totally speculative and will be easily spotted when frivolous or instituted only to harass the defendant.

1. Case Law

Two courts which have characterized a pledge as a sale under the 1934 Act have addressed whether a pledgee meets the purchaser-seller standing requirement set out in *Blue Chip*.²²⁵ In *Mallis v. Federal Deposit Insurance Company*,²²⁶ the Second Circuit Court of Appeals concluded that if the term "sale" is construed to include a pledge, the term "purchaser" should be construed consistently to include pledgees.²²⁷ The court provided no analysis of statutory language in arriving at this conclusion, but seems to have relied on the obvious sensibleness of the proposition for its support.²²⁸ The *Mallis* court observed that considering a pledgee to be a purchaser of securities is consistent with the policy behind the purchaser-seller requirement — preventing a limitless class of plaintiffs litigating speculative claims.²²⁹ The court stated that pledge transactions are based on loan contracts. The court reasoned that claims of loss based on pledge

(E.D. Pa. 1977). The court in *McCloskey* held that the transferor of a voting trust certificate was not a "seller" of a security. *Id.* at 995. *But see* *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977). In *Gross*, the court held that the beneficiary of a trust for which securities were bought was a purchaser of securities under the purchaser-seller requirement. *Id.*

²²⁵ See *Mallis v. Federal Deposit Ins. Corp.*, 568 F.2d 824, 829 (2d Cir.), *cert. granted sub nom.* Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979).

²²⁶ 568 F.2d 824 (2d Cir.), *cert. granted sub nom.* Bankers Trust Co. v. Mallis, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978).

²²⁷ 568 F.2d at 829.

²²⁸ The *Mallis* court also relied on its earlier holding in *SEC v. Guild Films Co.*, 279 F.2d 285, 289 (2d Cir.), *cert. denied sub nom.* Santa Monica Bank v. SEC, 364 U.S. 819 (1960), in asserting that once a pledge is characterized as a sale, a pledgee should be characterized as a purchaser under the 1934 Act. *Mallis*, 568 F.2d at 829 n.9. See note 10 *supra* for a discussion of *Guild Films*.

²²⁹ 568 F.2d at 829.

transactions are no more speculative than claims of loss based on more "traditional" sales agreements.²³⁰ Therefore, the court stated, granting standing to pledgees would not create an open-ended class of plaintiffs.²³¹ Hence, the court held that defrauded pledgees of securities are "purchasers" under *Blue Chip*.²³² Similarly, in *Mansbach v. Precott, Ball & Turben*²³³ the Seventh Circuit Court of Appeals held that a defrauded pledgee of securities was a purchaser under *Blue Chip* and has standing to sue under section 10(b).²³⁴ The *Mansbach* court did not question whether a pledgee should be considered a purchaser after it had characterized a pledge as a "sale." Rather, it merely assumed that the terms "sales" and "purchaser" should be read consistently.²³⁵ It passed on the issue without comment.²³⁶ The court did note, however, that pledge transactions arise in the context of concrete rights and expectations.²³⁷ Therefore, it considered its holding consistent with the policies of *Blue Chip*.²³⁸

2. Statutory Language

The statutory language of the 1934 Act also supports construing the term "purchaser" to include pledgees once a pledge is considered to be a "sale." The Act does not provide a definition of "purchaser" but it does define the term "purchase."²³⁹ Section 3(a)13 of the 1934 Act states that a "purchase" "include[s] any contract to buy, purchase, or otherwise acquire."²⁴⁰ The language of this section is very much like that of section 3(a)14 of the Act. Section 3(a)14 defines "sale" and provides that sales "include any contract to sell or otherwise dispose of."²⁴¹ Congress' use of such similar language in defining "purchase" and "sale"²⁴² indicates that it intended these terms to be construed uniformly.²⁴³ In addition, construing the terms "purchase" and "sale"

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.*

²³³ 598 F.2d 1017 (6th Cir. 1979).

²³⁴ *Id.* at 1029-30.

²³⁵ *Id.* at 1031.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.* at 1030.

²³⁹ 15 U.S.C. § 78c(a)(13) (1976).

²⁴⁰ *Id.*

²⁴¹ 15 U.S.C. § 78c(a)(14) (1976). See note 104 *supra* for text of provision.

²⁴² See 15 U.S.C. §§ 78c(a)(13), (14) (1976).

²⁴³ In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 n.19 (1976). The Court remarked:

To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another. . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressing him.

Id. (quoting *Addison v. Holly Hill Fruit Prods., Inc.*, 322 U.S. 607, 617-18 (1944)). This rule of common sense construction should be applied to the definitions of "purchase" and "sale" under the 1934 Act as there is no indication that they were not meant to cover the same transactions.

inconsistently would lead to the anomalous situation where parties on different sides of the same securities transaction would receive different protection under the Act. In *Blue Chip*, the Court indicated that the 1934 Act protects both purchasers and sellers of securities.²⁴⁴ This casenote has shown that in light of the Supreme Court's decision in *Rubin*, it is appropriate to consider the section 3(a)14 definition of "sale" to include pledges.²⁴⁵ To maintain consistency between the terms "sale" and "purchase" under the Act, if a pledge is considered a "sale" from the pledgor's point of view, then a pledge likewise should be considered a "purchase" from the pledgee's point of view. Assuming that one who "purchases" is a "purchaser," a pledgee should be considered a purchaser under the purchaser-seller standing requirement established by *Blue Chip*.

3. Policies behind *Blue Chip*

Finally, the policies behind *Blue Chip* purchaser-seller requirement for standing to sue under section 10(b) support granting standing to defrauded pledgees. The primary goals of the purchaser-seller requirement are to eliminate section 10(b) claims based on speculative losses instituted for either harassment or settlement purposes and to prevent the class of litigants suing under section 10(b) from becoming limitless.²⁴⁶ Granting standing to defrauded pledgees would not encourage the "vexatious litigation"²⁴⁷ that the Court seeks to curtail. The loss which would be claimed by pledgees suing under section 10(b) would be the unpaid amount of the debt for which the securities were pledged.²⁴⁸ Hence, the damages claimed by pledgees would be readily ascertainable on the basis of the contract. Such claims would not be speculative and would be less likely to be filed only for malicious reasons. In addition, granting standing to pledgees would not create a limitless class of plaintiffs. Pledgees are easily identified by the existence of a pledge contract.²⁴⁹ Because pledge transactions require such contracts, granting standing to pledgees would not open the class of plaintiffs suing under section 10(b) to "bystanders" to the securities markets who "await developments on the sidelines without risk" and later claim losses based on fraudulent acts or omissions.²⁵⁰ Allowing pledgees to sue under section 10(b) would create a limited class of federal litigants whose losses would be based on their actual participation in securities transactions.

The relevant case law, statutory language of the 1934 Act and policies of

²⁴⁴ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

²⁴⁵ See text and notes at notes 110-213 *supra*.

²⁴⁶ 421 U.S. at 733, 740, 752-54; *Mallis v. Federal Deposit Ins. Corp.*, 568 F.2d 824, 829 (2d Cir.), *cert. granted sub nom. Bankers Trust Co. v. Mallis*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381, 388 (1978).

²⁴⁷ *Id.*

²⁴⁸ *JONES*, *supra* note 8 § 5 at 9. The terms of a pledge agreement are formalized in a contract. Jones writes that "[t]here must, however, be a contract, either expressed or implied to constitute a pledge." *Id.* The existence of a contract reduces any possible speculative quality in a pledge transaction which would conflict with the concerns of *Blue Chip*, 421 U.S. at 742.

²⁴⁹ See note 248 *supra*.

²⁵⁰ *Blue Chip*, 421 U.S. at 747.

the *Blue Chip* purchaser-seller standing requirement all are consistent with characterizing a pledgee of stock as a "purchaser" of securities. Therefore, defrauded pledgees should have standing to sue for damages under section 10(b) of the 1934 Act.

II. LIMITS OF *RUBIN*

In *Rubin*, the Supreme Court relied on the language, legislative history and policies of the 1933 Act to hold that a pledge of securities is a "sale" of securities under the 1933 Act.²⁵¹ In light of this decision, it is equally appropriate to characterize a pledge of securities as a "sale" of securities under the 1934 Act. Analyzing the relevant statutory language, legislative history and policies of the 1934 Act against the backdrop of the Court's reasoning in *Rubin* makes it clear that pledges should be deemed sales under the 1934 Act.²⁵² In addition, following *Rubin* and characterizing a pledge as a "sale" under the 1934 Act leads to the further conclusion that pledgees of securities should be considered "purchasers" of securities under the 1934 Act.²⁵³ Characterizing pledgees as "purchasers" under the 1934 Act is significant because, as purchasers, pledgees could maintain a private action for damages under section 10(b) for fraud in connection with the pledge of securities.²⁵⁴ It has been submitted that allowing such private actions is consistent with the Supreme Court's effort to restrict the scope of private damage actions under section 10(b).²⁵⁵

While granting standing to pledgees is consistent with the Court's concern for restricting the class of plaintiffs eligible to sue under section 10(b), *Rubin* might also be read to support the grant of standing under section 10(b) to holders of partial interests in securities other than pledgees. This possible extension of *Rubin* exists because the *Rubin* Court established the principle that "it is not essential under the terms of the [1933] Act that full title pass to a transferee for the [securities] transaction to be an 'offer' or 'sale.'"²⁵⁶ The Court applied this principle to hold that the transfer of a partial interest in a security in a pledge transaction is a "sale" under the Act.²⁵⁷ Under the authority of this principle, however, other transfers of partial interest in securities also could be characterized as "sales." If other transfers are so characterized, then transferees of other partial interests in securities might be considered "purchasers" for the purposes of standing in a private action under section 10(b). Hence, using *Rubin* to support standing for pledgees in private actions under section 10(b) may open the door of section 10(b) private actions to all holders of partial interests in securities. Such a great expansion in the class of plaintiffs eligible to sue under section 10(b) would run counter to the

²⁵¹ *Rubin*, 449 U.S. at 430-31.

²⁵² See text and notes at notes 155-209 *supra*.

²⁵³ See text and notes at notes 213-50 *supra*.

²⁵⁴ See text and notes at notes 217-24 *supra*.

²⁵⁵ See note 205 *supra* for cases restricting private actions under § 10(b).

²⁵⁶ *Rubin*, 449 U.S. at 430.

²⁵⁷ *Id.* at 431.

Court's concern for restricting standing in such suits. Therefore, *Rubin's* application to section 10(b) private actions must be limited.

The principle established in *Rubin* that full title to a security need not pass for a "sale" of a security to occur²⁵⁸ should be limited to pledge transactions. The principle, if broadly read, would appear to extend beyond pledge transactions and encompass transfers of other partial interests in securities. The structure of the analysis in *Rubin*, however, indicates that the Court was only concerned with the "inchoate" interest transferred in a pledge transaction when stating that transfers of partial interests in securities could constitute sales.²⁵⁹ The Court's statement that "it is not essential under the terms of the Act that full title pass to a transferee for the transaction to be an 'offer' or 'sale' " follows a description by the Court of the specific interest in a security transferred in a pledge transaction.²⁶⁰ In this description, the Court recognized that the partial interest in a security transferred through a pledge is an "inchoate but valuable interest"²⁶¹ having three characteristics: pledgees obtain a power to gain full title to the securities through a "self-executing procedure" if the pledgor defaults on its obligations;²⁶² the self-executing procedure is exercised at the option of the pledgee;²⁶³ and a pledgee parts with valuable "consideration" to obtain the pledged securities.²⁶⁴ By positioning its elaboration of these characteristics of a pledge immediately after the statement that it is not essential for full title to pass for a "sale" to occur, the Court seems to suggest that it is not essential for full title to pass only when the inchoate interest created by a pledge transaction is transferred.

This restrictive reading of the *Rubin* Court's statement of principle is supported by the Court's analysis of the legislative history and policies of the 1933 Act.²⁶⁵ In addressing the legislative history of the Act, the Court did not focus on whether Congress intended to include transfers of partial interests in securities generally in the definition of "sale" under the Act.²⁶⁶ Rather, the Court only examined the legislative history of the Act as it related specifically to pledges.²⁶⁷ Similarly, the Court only analyzed whether the 1933 Act's policy of protecting individuals against loss in securities transactions extends to pledgees.²⁶⁸ The Court made no mention of the Act's concern for holders of other partial interest in securities.²⁶⁹ Therefore, a close reading of *Rubin* indicates that the Court had no intent to create a principle for defining the term "sale" under the securities acts which extends beyond the context of pledges.

²⁵⁸ *Id.* at 430.

²⁵⁹ *See id.* at 429.

²⁶⁰ *Id.* at 429-30.

²⁶¹ *Id.* at 429.

²⁶² *Id.*

²⁶³ *Id.*

²⁶⁴ *Id.*

²⁶⁵ *Id.* at 430.

²⁶⁶ *Id.*

²⁶⁷ *Id.*

²⁶⁸ *Id.* at 431.

²⁶⁹ *Id.*

The danger that *Rubin* may be used to enlarge greatly the class of plaintiffs suing under section 10(b) would be obviated by restricting the decision solely to pledge transactions. Restricting *Rubin*'s impact on the definition of "sale" under the securities acts to pledges would limit *Rubin*'s support for expanding the class of section 10(b) plaintiffs to pledgees. If *Rubin* were viewed as applying only to pledges and parties to pledge transactions, then *Rubin* would not open the door of section 10(b) private actions to holders of all partial interests in securities. Hence, *Rubin* can be construed to support the grant of standing under section 10(b) to defrauded pledgees of securities without undercutting the Court's concern for restricting such private actions.

CONCLUSION

Defrauded pledgees of stock should be granted standing to sue for damages under section 10(b) of the 1934 Act. In *Rubin v. United States* the Supreme Court relied on the language, legislative history and purposes of the 1933 Act to conclude that a pledge of a security is a "sale" of a security under the 1933 Act. The similar language, history and policies of the 1934 Act warrant following *Rubin* when interpreting the term "sale" under the 1934 Act. A pledge also should be deemed to be a sale under the 1934 Act. Once a pledge is characterized as a "sale" under the 1934 Act, pledgees should be considered "purchasers" of securities under *Blue Chip*. Both the language of the 1934 Act and logic require this conclusion. Since section 10(b) of the 1934 Act provides a private cause of action for purchasers of securities who suffer loss from fraudulent acts in connection with a "sale" of securities, defrauded pledgees should be allowed to sue for damages under section 10(b). Granting standing to pledgees in such actions does not frustrate the efforts of the Court to restrict the class of plaintiffs who can sue under section 10(b). Allowing pledgees to sue for damages is consistent with the *Blue Chip* policy of preventing vexatious litigation.

While *Rubin* conceivably could support a cause of action under section 10(b) for holders of partial interests in securities other than pledgees, this result need not follow from granting standing to pledgees. *Rubin* can and should be confined to its facts. A principled reading of the Court's opinion indicates that the Court meant only to bring pledges within the meaning of the term "sale." Therefore, holders of other kinds of partial interest in securities should not be deemed "purchasers" and considered eligible to sue under section 10(b).

ALBERT ANDREW NOTINI