

April 1979

Securities Law: Seventh Circuit Review of Remedies, Definitions, Standing and Sanctions

Michael B. Roche

Richard T. Zwirner

Follow this and additional works at: <https://scholarship.kentlaw.iit.edu/cklawreview>

 Part of the [Law Commons](#)

Recommended Citation

Michael B. Roche & Richard T. Zwirner, *Securities Law: Seventh Circuit Review of Remedies, Definitions, Standing and Sanctions*, 55 Chi.-Kent L. Rev. 203 (1979).

Available at: <https://scholarship.kentlaw.iit.edu/cklawreview/vol55/iss1/10>

This Article is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Chicago-Kent Law Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact dginsberg@kentlaw.iit.edu.

SECURITIES LAW: SEVENTH CIRCUIT REVIEW OF REMEDIES, DEFINITIONS, STANDING AND SANCTIONS

MICHAEL B. ROCHE*
RICHARD T. ZWIRNER** ***

The United States Court of Appeals for the Seventh Circuit has long stood at the forefront of innovation in applying the federal securities laws.¹ An example of this is the unique nature of the relief granted this term² by the Seventh Circuit in *Wright v. Heizer Corp.*³ While this term was otherwise a relatively quiet one in the Seventh Circuit,⁴ the court did render one decision with potentially significant overtones and two others which merit discussion in some detail. This article will discuss the relief granted in *Wright* and these three other Seventh Circuit decisions.

THE RELIEF GRANTED IN *WRIGHT V. HEIZER CORP.*

One of the most fascinating and challenging issues arising under the federal securities laws, and one of the least discussed by commentators generally, is the determination of the appropriate remedy for violations of those laws. In *J.I. Case Co. v. Borak*,⁵ a case arising under section 14(a) of the Securities Exchange Act of 1934,⁶ the United States Supreme Court described the broad scope of relief which federal courts are authorized to grant under the federal securities laws. In so doing, the Court stated:

* Partner, Hubachek, Kelly, Rauch & Kirby, P.C.; A.B. and J.D., University of Notre Dame.

** Partner, Hubachek, Kelly, Rauch & Kirby, P.C.; B.A., University of Michigan; J.D., Northwestern University.

*** The authors extend their grateful appreciation to Thomas J. Dillon for his able and thorough assistance in connection with this article.

1. 15 U.S.C. §§ 77a-78kk (1976).

2. The period herein referred to as the term runs from September 1, 1977, to May 31, 1978.

3. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

4. In the immediately preceding term the Seventh Circuit issued some major decisions. *See, e.g., Daniel v. Int'l Bhd. of Teamsters*, 561 F.2d 1223 (7th Cir. 1977), *cert. granted*, 98 S. Ct. 1232 (1978) and *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976). For a discussion of these cases *see* Curley & Marciniak, *Securities Law*, 54 CHI.-KENT L. REV. 498, 498-511 (1977) [hereinafter referred to as Curley & Marciniak].

5. 377 U.S. 426 (1964).

6. 15 U.S.C. § 78m(a) (1976) [hereinafter referred to as the 1934 Act].

We, therefore, believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose It is for the federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded.⁷

Similarly, the Supreme Court brought into focus the encompassing nature of relief available under the antifraud provisions of the 1934 Act⁸ in *Mills v. Electric Auto-Lite Co.*⁹ Speaking for the majority, Justice Harlan stated:

In devising retrospective relief for violation of the proxy rules, the federal courts should consider the same factors that would govern the relief granted for any similar illegality or fraud. One important factor may be the fairness of the terms of the merger In selecting a remedy the lower courts should exercise "the sound discretion which guides the determinations of courts of equity," keeping in mind the role of equity as "the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims."¹⁰

Pursuant to these directives, the relief traditionally granted by lower federal courts in securities fraud cases has included awards of money damages,¹¹ accountings¹² and injunctions against the consummation of mergers and other transactions tainted by violations.¹³ Only in the rarest of circumstances—under what typically involve complicated facts and circumstances—have the courts sought to revise the terms of illegal transactions to comport with their idea of fairness or with what they believe is "necessary to make effective the congressional purpose."¹⁴

7. 377 U.S. at 433.

8. 15 U.S.C. §§ 78i, 78j, 78r (1976).

9. 396 U.S. 375 (1970).

10. *Id.* at 386 (citations omitted).

11. *See, e.g.,* *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1051 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 991 (7th Cir. 1976); *Madigan, Inc. v. Goodman*, 498 F.2d 233, 239 (7th Cir. 1974); *Gerslue v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1305 (2d Cir. 1973).

12. *See, e.g.,* *Mueller v. Korholz*, 449 F.2d 82 (7th Cir. 1971), *cert. denied sub nom. Wolff v. Korholz*, 405 U.S. 922 (1972); *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *aff'd in part, rev'd in part*, 363 F.2d 507 (1966), *cert. denied*, 385 U.S. 1002 (1967); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

13. *See, e.g.,* *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1102 (2d Cir. 1972); *Latta v. Securities and Exch. Comm'n*, 356 F.2d 103, 103 (9th Cir. 1965), *cert. denied*, 384 U.S. 940 (1966); *Securities and Exch. Comm'n v. Pig'N Whistle Corp.*, 359 F. Supp. 219, 221 (N.D. Ill. 1973). *See also* *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973).

14. 396 U.S. at 386. For example, the Second Circuit indirectly attempted to do this in *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 516 F.2d 172 (2d Cir. 1975), *rev'd on other grounds*, 430 U.S. 1, *reh. denied*, 430 U.S. 976 (1977), when it enjoined the parties from voting shares they had acquired as a result of their securities laws violations. Without the injunction, the control of the corporation would have been significantly altered.

Departing from this tradition and consistent with its innovative application of the federal securities laws, as early as 1973, the Seventh Circuit laid the foundation for revising transactions found illegal under the Securities Act of 1933.¹⁵ In *Swanson v. American Consumers Industries, Inc.*,¹⁶ Judge Cummings stated that the lodestar for revising an illegal transaction under the federal securities laws was its *fairness*. However, the court went on to find that the terms of the transaction in issue, a merger, were fair and reasonable at the time it was effected. Accordingly, the court denied relief which would have operated as a revision of the terms of the merger.¹⁷ It was not until 1977, in *Wright v. Heizer Corp.*,¹⁸ that the Seventh Circuit actually employed the fairness standard previously formulated in *Swanson* to unravel and revise a securities transaction which had been accomplished in violation of the federal securities laws.

Wright grew out of a series of five transactions between International Digisonics Corporation¹⁹ and Heizer Corporation, an investor and eventually the controlling shareholder in I.D.C. I.D.C. was formed to provide an electronic monitoring system for television commercials. This system provided the means for advertising agencies to verify that their advertisers' commercials had in fact been aired at the proper times. Persistent technical and monetary shortcomings forced I.D.C. to call upon Heizer for financial assistance. This financing was furnished in five separate, but related, transactions between November 1969 and June 1973. These transactions consisted primarily of purchases by Heizer of I.D.C. preferred stock and of loans by Heizer to I.D.C. In the course of these transactions, Heizer gained control of I.D.C. In order to understand the relief granted by the district court, it is necessary to be familiar with the five transactions involved.²⁰

In the first transaction, Heizer purchased preferred stock of I.D.C., accompanied by warrants to purchase common stock, for \$1,000,000, and agreed to loan \$500,000 to I.D.C. for one year. The exercise price of the warrants was set at \$8.50 per share and there was added to the warrants an "antidilution clause" which would result in readjustment of the exercise price down, and the number of shares of common stock available to Heizer up, if I.D.C. sold common stock at less than \$8.50

15. 15 U.S.C. §§ 77a-77bbbb (1976) [hereinafter referred to as the 1933 Act].

16. 475 F.2d 516 (7th Cir. 1973).

17. *Id.* at 520.

18. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). This article will emphasize the relief aspects of the *Wright* decision. For a more general discussion of this case see Curley & Marciniak, *supra* note 4, at 514-16.

19. Hereinafter referred to as I.D.C.

20. See 560 F.2d at 242-45.

per share. I.D.C. also agreed not to pledge the stock of its profitable subsidiary, T & R, or to change the nature of its business without Heizer's consent.

In the second transaction, Heizer invested \$2,000,000 in two \$1,000,000 takedowns on the same general basis as the first transaction. Heizer was to receive more I.D.C. preferred stock and warrants with an exercise price of \$6.00 per share or, if I.D.C. failed to meet certain conditions by the time of the second takedown, \$4.00 per share. The warrants had the same "antidilution clause" as the earlier warrants, although Heizer waived its rights under the clause in the first set of warrants so that their exercise price stayed at \$8.50 per share.

In the third transaction, Heizer invested \$1,700,000 of which \$500,000 was used by I.D.C. to repay the loan from Heizer. Heizer received a twenty-year note and warrants with an exercise price of \$3.60 per share. The "antidilution clauses" in the earlier warrants were partially triggered and Heizer became entitled to purchase I.D.C. common stock, constituting 61% of I.D.C.'s total equity, at \$3.60 per share. Additionally, at this time two Heizer officers became directors of I.D.C. These first three transactions were unanimously approved by I.D.C.'s board of directors and stockholders.

In the fourth transaction, Heizer agreed on November 19, 1971, to loan I.D.C. \$600,000. If this amount was not repaid by March 31, 1972, it was to be converted into common stock at \$1.00 per share and the "antidilution clauses" from the first three transactions were to be triggered, enabling Heizer to purchase eighty-five per cent of I.D.C.'s equity at \$1.00 per share. I.D.C.'s charter had to be amended to increase the amount of authorized common stock to facilitate any purchases by Heizer of additional shares at the \$1.00 price. This was accomplished by obtaining written consents permitted under the Delaware General Corporation Law from a sufficient number of stockholders. On March 13, 1972, Heizer lent I.D.C. an additional \$250,000 on basically the same terms. The loans were not repaid by March 31, 1972, and Heizer gained the right to purchase common stock at \$1.00 per share. In addition, three Heizer nominees formally took control of I.D.C.'s board and later elected a fourth director over the objection of the non-Heizer director. Over the next year Heizer extended an additional \$2,015,000 to I.D.C. in the form of demand loans.

In the fifth transaction,²¹ Heizer took as security for its demand

21. The fifth transaction was consummated after the bench trial in the district court. However, in the final opinion, this transaction was considered by the court. See text accompanying notes 25-26, *infra*.

loans a pledge of all of the stock of T & R. In return, Heizer agreed to postpone demand on various loans and to lend a minimum of \$460,000 and a maximum of \$1,181,700 to I.D.C. from June 1973 to the end of 1973. These loans were repayable on January 1, 1974. These last two transactions were approved by I.D.C.'s board of directors.

In October 1972, between the fourth and fifth transactions, minority and other stockholders of I.D.C. brought an action against Heizer. They charged that after Heizer had gained control of I.D.C., it had violated section 10(b) of the 1934 Act²² and rule 10b-5²³ promulgated by the Securities and Exchange Commission thereunder, by failing to disclose its controlling position to I.D.C. stockholders and by improperly valuing I.D.C. stock in the three prior transactions.²⁴

After a bench trial, the district court held that there were no federal securities law violations in connection with the first three transactions.²⁵ As for the fourth and fifth transactions, however, Judge Prentice Marshall, after careful scrutiny, found that Heizer had breached a fiduciary duty owed to I.D.C. and that these breaches constituted violations of section 10(b) and rule 10b-5.²⁶ The district court then directed its efforts to fashioning relief in connection with the fourth and fifth transactions while leaving the first three transactions essentially intact.

In revising the fourth transaction, Judge Marshall eliminated the convertibility feature of the notes and enjoined Heizer from converting, or attempting to convert, any notes to shares of I.D.C. common stock.²⁷ Judge Marshall then declared void the charter amendment which authorized an increase in the number of shares of common stock. Judge Marshall also voided all provisions which would allow Heizer to exercise the previously acquired warrants at a price below \$3.60 per share.²⁸ Accompanying this action was an injunction preventing Heizer from attempting to enforce the voided provisions of the fourth transaction.²⁹

As for the fifth transaction, the district court voided the agreement by which I.D.C. had pledged its stock in T & R as security for various loans previously extended by Heizer to I.D.C. and ordered Heizer to

22. 15 U.S.C. § 78j(b) (1976).

23. 17 C.F.R. § 240.10b-5 (1978).

24. 560 F.2d at 244.

25. 411 F. Supp. 23, 35 (N.D. Ill. 1975), *aff'd in part, rev'd in part*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

26. *Id.* at 36-37.

27. *Id.* at 37.

28. *Id.*

29. *Id.*

release any security interest it had acquired in the T & R stock.³⁰ Heizer was further enjoined from attempting to enforce the pledge agreement in any way.³¹ Finally, Judge Marshall found it necessary to enjoin Heizer from entering into any future transaction with I.D.C. "except upon terms and conditions as shall be fair and equitable."³²

After Judge Marshall had rendered his decision, Heizer proposed a plan of recapitalization to I.D.C.'s stockholders and "threatened to put [I.D.C.] into bankruptcy if the plan was not approved by them."³³ The district court enjoined implementation of the plan pending appeal to the Seventh Circuit. The district court also entered an injunction at that time preventing Heizer from collecting any interest or principal on loans it had made to I.D.C.³⁴ While *Wright* was on appeal to the Seventh Circuit, the Supreme Court decided *Santa Fe Industries, Inc. v. Green*.³⁵ Although the Seventh Circuit found Judge Marshall's reasoning for imposing liability to be erroneous in light of this decision, it nevertheless affirmed his finding of liability associated with the fourth and fifth transactions on other grounds.³⁶

In focusing upon the proper relief to be afforded, the Seventh Circuit, speaking through Judge Tone, found the controlling standard to be the one previously set forth in *Mills*.³⁷ Judge Tone summarized that principle as follows:

In granting relief in a case such as this, a court of equity should attempt to return the parties to the *status quo ante*, unraveling transactions effected through violations of Rule 10b-5 to the extent that it may do so fairly and without injuring the rights of innocent parties.³⁸

Upon review of the relief granted by the district court, the Seventh Circuit affirmed the cancellation of the conversion feature of the notes in the fourth transaction and the cancellation of the charter amendment increasing the number of authorized shares of I.D.C. common stock. The court also affirmed the nullification by the district court of

30. *Id.* at 37-38.

31. *Id.* at 38.

32. *Id.*

33. 560 F.2d at 253.

34. *Id.*

35. 430 U.S. 462 (1977).

36. The Seventh Circuit ruled that, in light of *Sante Fe*, the district court's finding of a breach of fiduciary duty would not alone be sufficient to support a finding of liability. Applying the Supreme Court's reasoning in *Sante Fe*, the Seventh Circuit found it was necessary that there be some deception or non-disclosure, along with a breach of fiduciary duty, before there would be a violation of section 10(b), 15 U.S.C. § 78j(b) (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1978). The Seventh Circuit concluded, however, that Heizer had also failed to disclose material information which, independent of any breach of fiduciary duty, constituted a violation of section 10(b) and rule 10b-5. 560 F.2d at 246.

37. 396 U.S. 376 (1970), noted at 560 F.2d at 252.

38. 560 F.2d at 252.

the pledge agreement that made up the fifth transaction. In addition, the court confirmed the injunction preventing Heizer from going ahead with its proposed plan of recapitalization.³⁹

Acting upon a petition for supplemental relief not considered by the district court,⁴⁰ the Seventh Circuit ruled that the district court, on remand, should review and adjust the maturities of the loans made by Heizer to I.D.C. in the fourth and fifth transactions.

The Seventh Circuit itself reviewed the maturity features of the loans made after the third transaction in order to determine the fairness of their terms. The court's intent was made clear when, in considering the propriety of subordinating the loans, it stated: "[T]he only inquiry that remains is whether the terms of the loans, apart from the convertibility feature and the security that have already been nullified, were fair to IDC and its common shareholders."⁴¹ The court found that since the maturity features were no more than a "heads-I-win-tails-you-lose-series of transactions" they were unfair and "should be adjusted to make them commensurate with IDC's ability to pay."⁴²

With respect to the prospective relief granted by the district court, Heizer had contended that the injunction issued preventing it from entering into any agreement with I.D.C. which is not "fair and equitable" was too vague. The Seventh Circuit deleted that provision and placed in its stead directions to Heizer.⁴³ The injunction as modified by the Seventh Circuit provided that Heizer disclose to I.D.C. any and all material facts concerning further securities transactions it might propose.

The Seventh Circuit further enjoined Heizer from entering into any securities transaction with I.D.C. which did not have the approval of the majority of I.D.C. stockholders other than Heizer or, in the alternative, the approval of the district court or another court having jurisdiction to make a determination that the proposed transaction would be fair and equitable.⁴⁴ The Seventh Circuit then relieved Heizer of the restriction imposed by the district court requiring Heizer to pay \$3.60 per share of I.D.C. common stock upon exercise of its warrants.⁴⁵

Rather than returning the parties to the *status quo ante* within the meaning of the standard enunciated in *Mills*, the relief granted by the

39. *Id.* at 252-55.

40. The district court refused to consider the petition for supplemental relief on the basis that it was not timely filed. However, the Seventh Circuit disagreed in the modified opinion and considered the merits of the petition. *See* 560 F.2d at 253-54.

41. *Id.* at 254.

42. *Id.*

43. *Id.* at 255-56.

44. *Id.* at 256.

45. *Id.*

Seventh Circuit placed the parties in different positions within the structure of the fourth and fifth transactions.⁴⁶ An argument to this effect was made by Heizer in its unsuccessful petition for a writ of certiorari to the Supreme Court.⁴⁷ In this petition Heizer argued that the action taken by the Seventh Circuit went beyond "unraveling" the financing transactions and amounted to "restructuring" them—action which is beyond the power of a federal court.⁴⁸ According to Heizer, a federal court acting under the federal securities laws is empowered to *void* a transaction, but not to *modify* it.⁴⁹ While Heizer's characterization of the relief granted as a "restructuring" rather than an "unraveling" is accurate, under the plain and explicit mandate of the Supreme Court in *Borak* and *Mills* it seems clear that a federal court is empowered to do either.

By the Seventh Circuit's decisive action, Heizer's control over I.D.C. was lessened and I.D.C.'s obligations to Heizer were reduced to a level more commensurate with I.D.C.'s ability to operate. In effect, the court significantly altered the original bargain struck by the parties. As a result, many of the risks in the transactions were shifted from I.D.C., where they were originally placed by the agreements between the parties, to Heizer.

Wright stands as a signal to all parties entering into agreements and transactions subject to the standards set forth in the federal securities laws that a violation of those laws may very well result in a judicial balancing of the terms of the original agreement, as an alternative to an award of money damages or the entry of injunctive relief. If the original agreement is found to be "unfair," the court may modify or substitute new terms for those negotiated and agreed to by the parties.

THE DEFINITION OF A SECURITY IN *HIRK V. AGRI-RESEARCH COUNCIL, INC.*

In *Hirk v. Agri-Research Council, Inc.*,⁵⁰ the Seventh Circuit held that a sharing or pooling of funds is required to form an "investment contract" within the meaning of the statutory definitions of "security" in the 1933 and 1934 Acts.⁵¹ This opinion reaffirms the Seventh Cir-

46. *E.g.*, the maturity dates of the loans were to be "adjusted to make them commensurate with IDC's ability to pay." *Id.* at 254. *See* text accompanying notes 40-42, *supra*.

47. The petition was denied on February 21, 1978. *See* 434 U.S. 1066 (1978).

48. Heizer's Brief for Certiorari at 26-28.

49. *Id.*

50. 561 F.2d 96 (7th Cir. 1977).

51. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1976).

cuit's decision in *Milnarik v. M-S Commodities*⁵² and the interpretation the *Milnarik* court placed on the tripartite test set forth by the Supreme Court in *SEC v. W.J. Howey Co.*⁵³

In his original complaint, Hirk charged that he was fraudulently induced to enter into a written trading agreement with Agri-Research Council Inc.,⁵⁴ a company engaged in managing discretionary futures trading accounts. In reliance on various misrepresentations concerning the defendants' expertise and their failure to inform Hirk of the high risk nature of his investment, the plaintiff placed \$10,000 in a trading account and executed a power of attorney which authorized an officer of A.R.C.O. to trade in his account as his agent and attorney-in-fact. Hirk lost his \$10,000 initial investment as well as an additional \$17,800 which was charged to his account to cover other trading losses.

Hirk alleged that the written discretionary trading agreement and the power of attorney each constituted an "investment contract" or a "certificate of interest or participation in a profit sharing agreement," thus qualifying each as a "security" under the 1933 and 1934 Acts.⁵⁵ Accordingly, under Hirk's theory, the defendants were liable to him for violations of the securities laws because they had not registered these securities as required by section 5 of the 1933 Act⁵⁶ and had not complied with the antifraud provisions of the 1933 and 1934 Acts⁵⁷ or the rules promulgated thereunder.⁵⁸

Count I of Hirk's original complaint was dismissed by the district court on the ground that his arrangement with the defendants was not an "investment contract," and therefore not a "security," because the necessary element of "common enterprise" was lacking.⁵⁹ Hirk then amended count I alleging that the defendants handled all their discretionary trading accounts in such a fashion that Hirk participated with the other account holders "as if" all their funds were commingled. The district court dismissed count I, as amended, on the ground that the requisite element of a "common enterprise" was absent, "especially in light of plaintiff's claim that such treatment was in direct contravention

52. 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

53. 328 U.S. 293 (1946).

54. Hereinafter referred to as A.R.C.O.

55. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1976).

56. 15 U.S.C. § 77e (1976).

57. 15 U.S.C. §§ 77q, 78j(b), 78o(c) (1976).

58. 17 C.F.R. §§ 240.10b-5, 240.15c1-2, 15c1-7 (1978).

59. While Hirk's claim in count I was based upon his theory that the written trading agreement and the written power of attorney each constituted a "security," the Seventh Circuit considered the two together as comprising "the arrangement" with A.R.C.O. 561 F.2d at 99.

of defendants' representations and plaintiff's expectations."⁶⁰

In dismissing count I, both in its original and amended forms, the district court relied solely upon the Seventh Circuit's decision in *Milnarik v. M-S Commodities, Inc.*⁶¹ In *Milnarik*, the Seventh Circuit had held that before a trading agreement could qualify as a "security," a "common enterprise" must be shown to exist. That is, there must be present multiple investors whose funds are pooled together for the same purpose so that the holders of all similar accounts may be considered joint participants in the same investment enterprise.

At the outset of the Seventh Circuit's opinion in *Hirk*, Judge Cummings recognized that in order to reverse the dismissal of Hirk's complaint, the court would be required to overrule its decision five years earlier in *Milnarik*.⁶² It declined to do so.

In *Milnarik*, Judge Stevens (now Supreme Court Justice Stevens) had held that a contract pursuant to which certain investors deposited their funds with a broker on the understanding that the broker would use those funds in his sole discretion to trade commodities futures for their benefit did not constitute a "security" even though the broker had entered into virtually identical discretionary agreements with other customers. Judge Stevens noted that the "common enterprise" element was required to create a "security" under the test outlined over twenty years earlier by the Supreme Court in *SEC v. W.J. Howey Co.*⁶³ Applying the *Howey* test to the facts before him, Judge Stevens found that the success or failure of the trading in the other discretionary accounts had no direct or economic bearing upon the profitability of the plaintiff's account. Since the plaintiff and the other customers of the same broker were not joint participants in the same investment enterprise, no "common enterprise" was present.⁶⁴

Both the *Hirk* and *Milnarik* decisions involved an application of the test enunciated by the Supreme Court in *Howey*. In that landmark opinion, the Supreme Court, speaking through Justice Murphy, stated:

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

. . . .

60. *Id.*

61. 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).

62. 561 F.2d at 99.

63. 328 U.S. 293 (1946).

64. 457 F.2d at 276-77.

. . . The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.⁶⁵

Under the *Howey* test for an “investment contract” it is clear, and it has been repeatedly held, that three distinct elements must be present: (1) the investment of money; (2) a common enterprise among several investors and (3) the expectation of profits to be derived solely from the efforts of others.⁶⁶

While the first element lends itself to easy analysis, the second and third elements do not. The Supreme Court in *Howey* did not define “common enterprise,” it did not delineate the emphasis to be accorded these two elements and it did not specify whether an “investment contract” could arise if one of these elements were absent. In short, other than to formulate its tripartite test, the Court failed to provide the lower courts with any additional parameters for application of its test to constantly changing and often complicated schemes to defraud.

In *Milnarik*, the Seventh Circuit applied the three-pronged test of *Howey* and found that the second element—the existence of a “common enterprise”—was lacking. Accordingly, it held the trading account at issue did not involve a “security.”

In *Hirk*, the Seventh Circuit reapplied the literal, almost mechanical approach of *Milnarik* and held that *Hirk* simply failed to establish the second element under the *Howey* test—the presence of a “common enterprise.” Judge Cummings first reiterated Judge Stevens’ preoccupation in *Milnarik* with the necessity of a “common enterprise.” While Judge Cummings admitted that in *Milnarik* Judge Stevens had not expressly decided that the existence of a “common enterprise” subsumes the existence of a pooling of funds or the sharing of profits on a pro rata basis,⁶⁷ he proceeded to conclude that Judge Stevens had nevertheless assumed such a pooling or sharing was required under the *Howey* test. In doing so, Judge Cummings stated: “It is apparent then that this Court’s decision in *Milnarik* was based on the assumption that a sharing or pooling of funds is required by *Howey*, and we are unwilling to

65. 328 U.S. at 298-300. While the Supreme Court in *Howey* discussed the term “investment contract” as it appears in the statutory definition of “security” in the 1933 Act, it should be noted that the definition of “security” under both the 1933 and 1934 Acts is virtually identical. See *United Hous. Foundation v. Forman*, 421 U.S. 837, *reh. denied*, 423 U.S. 884 (1975); *Nash & Assocs., Inc. v. Lum’s of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973). In *Hirk*, Judge Cummings agreed. 561 F.2d at 99.

66. See, e.g., *Securities and Exch. Comm’n v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Securities and Exch. Comm’n v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

67. Judge Cummings conceded that in *Milnarik*, the court “did not directly address the pooling issue.” 561 F.2d at 100.

overrule that determination.”⁶⁸ Having conceptually bridged this gap in his threshold analysis, all that remained was the simple question of whether Hirk’s funds had in fact been pooled or whether Hirk had shared in profits on a pro rata basis. Since Hirk had not made such allegations, the court held that this arrangement did not comprise a “common enterprise.” In addition, the court found Hirk’s allegation, in amended count I—that his account was treated “as if” commingled—insufficient on its face to satisfy the pooling requirement. Accordingly, the Seventh Circuit affirmed the district court’s dismissals of count I—both in its original form and as amended.⁶⁹

The question of whether or not the “common enterprise” requirement of *Howey* requires a pooling of funds or sharing of profits has prompted inconsistent results among the circuits.⁷⁰ Similar to the *Hirk* analysis, several courts have interpreted “common enterprise” as requiring that a relationship exist among *investors*. Their monies or investment proceeds are pooled in the same enterprise or the profits generated by the enterprise are shared by the investors on a pro rata basis.⁷¹ This method of determining whether the “common enterprise”

68. *Id.* at 101.

69. Hirk also claimed that since a clause in his trading agreement required that 25% of the profits accruing in his account in a one month period were to be paid to A.R.C.O. as compensation for its advisory services, his trading agreement constituted a “certificate of interest or participation in a profit sharing agreement” as those terms are used in the statutory definitions of “security” under both the 1933 and 1934 Acts, 15 U.S.C. §§ 77b(1), 78c(a)(10) (1976). See text accompanying note 53, *supra*. In an abbreviated analysis, Judge Cummings rejected this contention and held that no distinction exists between “investment contracts” and “profit sharing plans.” Accordingly, since Hirk’s arrangement lacked the element of a “common enterprise,” it failed to qualify as a “certificate of interest or participation in a profit sharing agreement,” for the same reasons it had failed to qualify as an “investment contract.” 561 F.2d at 102-03. Because this conclusion was based upon the court’s interpretation of the “common enterprise” requirement, an analysis of this part of the court’s decision in *Hirk* is outside the scope of this article. See Shine, *Commodities Laws: Investor Protection or Abandonment*, 55 CHI.-KENT L. REV. 73, 73-9 (1979).

70. In his opinion in *Hirk*, Judge Cummings recognized one contrary position taken after the decision in *Milnarik* by the Fifth Circuit in *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974), and expressly rejected it. 561 F.2d at 101.

71. For example, in *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff’d without opinion*, 491 F.2d 752 (3d Cir. 1973), the district court held that a discretionary trading account in commodities futures did not, absent an allegation of a pooling of funds among other investors with similar accounts, constitute a security thereby entitling the investor to sue under the antifraud provisions of the federal securities laws. Similarly, in *Consolo v. Hornblower & Weeks-Hemphill, Noyes, Inc.*, 436 F. Supp. 447 (N.D. Ohio 1976), it was held that a non-discretionary trading account in commodity futures lacked the required commonality because plaintiff’s investments were independent of all other investors transacting business with the same broker defendant. The court also emphasized that since the account was non-discretionary, the plaintiff’s profits would not arise “solely from the efforts of others” as required under the *Howey* test. See also *Jenson v. Continental Fin. Corp.*, 404 F. Supp. 792 (D. Minn. 1975); *Glazer v. National Commodity Research and Statistical Serv., Inc.*, 388 F. Supp. 1341 (N.D. Ill.), *aff’d*, 547 F.2d 392 (7th Cir. 1974); *Arnold v. Bache & Co.*, 377 F. Supp. 61 (M.D. Pa. 1973).

requirement has been met is sometimes referred to as the "horizontal" approach.

In contrast to this horizontal approach, other courts have focused primarily upon the relationship between the investor and the promoter (or broker) to determine whether the requisite "common enterprise" is present. Under this test, which may be seen as a balanced fusion of the second and third elements required by *Howey*, a "common enterprise" will be held to exist as long as the fortunes of all investors are tied to the efforts of the same promoter. Interdependence among investors or a pro rata sharing of profits or pooling of funds is not required. This approach is frequently referred to as the "vertical" approach to the "common enterprise" requirement.⁷²

The majority of courts when confronted with the "common enterprise" issue have, under analogous facts and circumstances, adopted the "vertical" approach over the "horizontal" approach.⁷³ The majority approach appears to be the better reasoned of the two and therefore we submit that the decision in *Hirk* is unsound. First, in reaching its conclusion in *Hirk*, and thus reaffirming its rigid adherence to the "horizontal" approach previously enunciated in *Milnarik*, the Seventh Circuit misread the Supreme Court's holding in *Howey*. A careful examination of the authorities cited in *Howey* clearly reveals that the Supreme Court did not intend that the additional requirement of a pooling of funds or sharing of profits be present to find a "common enterprise."⁷⁴

72. In the leading case espousing the "vertical" approach, the Court of Appeals for the Ninth Circuit stated that regardless of whether investor funds are pooled or profits shared, the "common enterprise" requirement is satisfied if the relationship between investor and broker "is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties." *Securities and Exch. Comm'n v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476; 482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973). *Accord*, *Securities and Exch. Comm'n v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977). See also *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974); *Securities and Exch. Comm'n v. Koscot Interplantetary Inc.*, 497 F.2d 473 (5th Cir. 1974); *Nash & Assocs., Inc. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973).

73. See, e.g., *Mahue v. Reynolds and Co.*, 282 F. Supp. 423 (S.D.N.Y. 1967) (joint account with a brokerage firm under an agreement whereby the firm would manage the account held to be an investment contract, notwithstanding the absence of a pooling of funds or a common enterprise among investors); *Securities Investor Protection Corp. v. Associated Underwriters, Inc.*, 423 F. Supp. 168 (C.D. Utah 1975) (arrangement under which investors deposited funds with broker to be utilized by the broker in its sole discretion in securities trading held to satisfy the "common enterprise" requirement of *Howey* and to comprise a "security"); *Rochkind v. Reynolds Sec., Inc.*, 388 F. Supp. 254 (D. Md. 1975) (commodities contracts purchased by investor in reliance upon expertise of broker held, standing alone, to constitute "securities"); *Marshall v. Lamson Bros. & Co.*, 368 F. Supp. 486 (S.D. Iowa 1974) (discretionary commodities trading accounts held to satisfy the "common enterprise" requirement of *Howey* even though no pooling of funds or sharing of profits was present).

74. In imposing a "common enterprise" requirement upon the existence of an investment

Moreover, in utilizing a literal interpretation of the *Howey* test, the *Hirk* court overlooked the unmistakably clear directive embodied in the *Howey* opinion itself. The definition of security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."⁷⁵ Second, in reaching the result it did in *Hirk*, the Seventh Circuit ignored various Supreme Court admonitions that "the reach of the [Securities] Act does not stop with the obvious and commonplace"⁷⁶ and that "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."⁷⁷

Although other jurisdictions have adopted a flexible and malleable construction of "common enterprise,"⁷⁸ the Seventh Circuit has not. Rather, by its refusal to alter its strict interpretation of the *Howey* test and by its allegiance to its decision in *Milnarik*, the Seventh Circuit has severely undercut the remedial nature of the federal securities laws. In addition, the court has eviscerated the usefulness of those laws in preventing increasingly inventive schemes of modern times. For example, under the Seventh Circuit's rationale, a broker who patently misrepresents the profitability of his account and who fraudulently induces investors to place their funds with him, for use in his sole discretion, does not violate the antifraud provisions of the federal securities laws.

contract, the *Howey* Court relied heavily upon the Minnesota Supreme Court's earlier decision in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920). An analysis of that decision, however, reveals that while a pooling of funds was involved under the facts at issue there, nowhere did the Minnesota Supreme Court single out that particular element as essential to the existence of a "common enterprise." This reading of *Gopher Tire* is buttressed by the decision of the Minnesota Supreme Court two years later where it upheld the existence of a common enterprise under facts not involving any pooling of funds or sharing of profits. See *State v. Evans*, 154 Minn. 95, 191 N.W. 425 (1922). Moreover, no pooling of funds or sharing of profits was present in two of the other decisions relied upon by the *Howey* Court. See *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. 331 (1930); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940).

We suggest that careful analysis of the relevant authorities and of the legislative purpose sought to be achieved by the federal securities laws requires that the proper weight to be given the existence of a pooling of funds is that advanced by Professor Loss who states: "In all these cases proof of some sort of pooling arrangement among investors . . . helps, but it is not essential." I LOSS, *SECURITIES REGULATION* 489 (2d ed. 1961) (footnotes omitted).

75. 328 U.S. at 299.

76. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

77. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

78. See, e.g., *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974); *Securities and Exch. Comm'n v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Securities and Exch. Comm'n v. Koscot Interplanetary Inc.*, 497 F.2d 473 (5th Cir. 1974); *Nash & Assocs., Inc. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973); *Securities and Exch. Comm'n v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973); *Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977). All of these cases have adopted the "vertical" view of "common enterprise."

Equally troublesome and left unanswered by the *Hirk* analysis is the not uncommon situation where, unknown to the investor, his funds are pooled by his broker with those of other investors and may be used by the broker for a variety of improper purposes. Among these purposes may be the investment in a security in which the broker has a financial interest or the undisclosed use of the pooled funds by the broker for his own interest.

To summarize, the Seventh Circuit has exalted form over substance. It has imposed very narrow parameters on the definition of a "security" which frustrate the spirit and purpose underlying the antifraud provisions of the 1933 and 1934 Acts. Indeed, future application of the *Hirk* decision may render the antifraud provisions of the federal securities laws inoperative with respect to a large number of creative and ingenious schemes with endless permutations; schemes in which unscrupulous brokers or promoters may extract large investments from hapless investors under the fraudulently represented guise of earning a profit. This is one of the very evils which the federal securities laws were designed to prevent. The Seventh Circuit's decision in *Hirk* constitutes a narrow application of the federal securities laws decried by the United States Supreme Court on several occasions and contravenes the avowed goal of affording broad protection to the investing public.

DEVELOPMENTS UNDER THE INVESTMENT COMPANY ACT OF 1940

During the period under consideration, the Seventh Circuit also decided one case arising under the Investment Company Act of 1940,⁷⁹ *Mathers Fund, Inc. v. Colwell Co.*⁸⁰ In this case, the court held that the plaintiffs did not have standing to bring an action under the Investment Act. The court came to this conclusion after reviewing the Act's legislative purpose.

In *Mathers Fund*, the defendant Colwell Company, a publicly held corporation engaged in the mortgage finance business, purchased over five per cent of its own outstanding voting securities from the defendant Mathers Fund Incorporated.⁸¹ The Fund is an open end investment company registered under the Investment Company Act of 1940.⁸² Eight months after the purchase, the Fund sought a return of these shares and tendered to Colwell the original purchase price in ex-

79. 15 U.S.C. §§ 80a-1 to 80a-52 (1976) [hereinafter referred to as the Investment Act].

80. 564 F.2d 780 (7th Cir. 1977).

81. Hereinafter referred to as the Fund.

82. 15 U.S.C. § 80a-8 (1976).

change for their return.⁸³ After Colwell refused to return the shares and to accept the Fund's tender of the purchase price, the Fund initiated an action in the United States District Court for the Northern District of Illinois. Pursuant to section 46(b) of the Investment Act,⁸⁴ the Fund sought rescission of the purchase and the return of the shares sold to Colwell.

The gravamen of the Fund's complaint was that immediately prior to the purchase, the Fund owned more than five per cent of Colwell's outstanding securities. The Fund contended that under section 2 of the Investment Act⁸⁵ Colwell occupied the status of "an affiliated person" to the Fund immediately prior to the purchase. Accordingly, Colwell's purchase from the Fund violated section 17(a)(2) of the Investment Act which prohibits an "affiliated person" from knowingly purchasing any security from a registered investment company.⁸⁶ Section 46(b) of the Investment Act declares any agreement in violation of the Act to be void.⁸⁷ It was on this basis that the Fund sought rescission of the transaction.

Colwell moved to dismiss the complaint under rule 12(b)(6) of the Federal Rules of Civil Procedure⁸⁸ on the ground that it failed to state

83. Although the opinion is not clear, the Fund's attempt to repurchase the shares was apparently prompted by an increase in their market value after the sale to Colwell Company.

84. 15 U.S.C. § 80a-46(b) (1976).

85. Section 2 of the Investment Act, 15 U.S.C. § 80a-2(a)(3) (1976) provides:

"Affiliated person" of another means . . . (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled or held with power to vote, by such other person

86. 15 U.S.C. § 80a-17 (1976) provides:

(a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in Section 80a-12(d)(3)(A) and (B) of this title), or any affiliated person of such person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer)

87. 15 U.S.C. § 80a-46(b) (1976) provides:

(b) Every contract made in violation of any provision of this subchapter or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this subchapter, or any rule, regulation, or order thereunder shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order.

88. FED. R. CIV. P. 12(b)(6).

a claim upon which relief could be granted. Finding that the Fund was not an innocent party to Colwell's purchase and that the parties were therefore *in pari delicto*, Judge Grady granted Colwell's motion and dismissed the complaint.

On appeal, the Seventh Circuit⁸⁹ defined the issue before it to be whether the district court had erred in holding that the Fund was not entitled to the rescissional relief it requested.⁹⁰ The Seventh Circuit affirmed the district court's dismissal of the case, but in doing so did not adopt the district court's reasoning.

At the outset of his opinion, Judge Markey agreed with the argument that the district court acted improperly in finding the Fund to be *in pari delicto*. In doing so, Judge Markey noted the broad implication of a contrary result. He held that to let the district court's dismissal stand on the basis that the Fund was *in pari delicto* "could render § 17(a) a nullity if it were to preclude suit by any investment company against an affiliate who had purchased securities in apparent violation [of the Investment Act]."⁹¹

Judge Markey then affirmed the result reached in the district court on grounds apparently not even raised in the district court. He first examined the legislative history of the Investment Act⁹² and found its overall purpose was to protect registered investment companies from self-dealing and abuse by insiders. In reaching this conclusion, the court relied upon the prophylactic nature of the Investment Act and upon the SEC's authority to exempt a transaction otherwise in violation of section 17(a) if the terms of the agreement at issue are fair and reasonable and do not involve any overreaching.⁹³

Judge Markey then turned to an analysis of the complaint to deter-

89. The appeal was decided by a panel consisting of Seventh Circuit Judges Castle and Wood, and Chief Judge Markey of the United States Court of Customs and Patent Appeals who was sitting by designation. Judge Markey wrote the opinion. See 564 F.2d at 782.

90. *Id.* at 783.

91. *Id.* at 783 n.5.

92. S. REP. NO. 1775, 76th Cong., 3d Sess. 7 (1940).

93. Section 17(b) of the Investment Act, 15 U.S.C. § 80a-17 (1976) provides:

(b) Notwithstanding subsection (a) of this section, any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of said subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

- (1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;
- (2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this subchapter; and
- (3) the proposed transaction is consistent with the general purposes of this subchapter.

mine whether it stated a claim upon which relief could be granted, when measured against the purpose of the Act—the protection of registered investment companies against self-dealing and abuse by insiders. Since the complaint did not allege any overreaching on the part of Colwell, Judge Markey affirmed the dismissal for failure to state a claim.

In doing so, Judge Markey also focused upon a letter the Fund had written to the SEC in connection with the Colwell purchase which had been attached to the Fund's complaint as an exhibit. In this letter, the Fund had stated to the SEC that the price per share paid to the Fund by Colwell had been "fair and reasonable." This simply reinforced Judge Markey's conclusion that, by its own admission, the Fund had not been victimized by any overreaching or self-dealing by insiders and therefore that the evils which the Investment Act was designed to remedy were not present. Furthermore, under Judge Markey's analysis, in view of its letter, the Fund could not "in good faith" prove at trial that Colwell had "overreached."⁹⁴

Moreover, Judge Markey held that not only was the Fund's claim outside the protection of the Act but that granting the relief sought by the Fund would subvert the very policies the Investment Act was designed to advance. Judge Markey noted that the Fund was engaging in "speculation" when it sold the stock to Colwell. To allow it to utilize the Investment Act to rescind this sale and thus reap a profit upon resale at the presently higher price would, according to Judge Markey, be inequitable and contrary to the policies of the Investment Act. This was an additional basis upon which the Seventh Circuit affirmed the district court's dismissal of the Fund's complaint.⁹⁵

To the extent that Judge Markey affirmed the dismissal of the Fund's complaint for its failure *to allege* it was within the class of persons protected by the Investment Act, the court's analysis is well reasoned and stands on solid ground. However, to the extent the court determined *as fact* that the Fund could not prove it was within the category of persons protected by the Act, the decision would better have been reached in the context of a trial on the merits where the Fund would be permitted to explain its letter to the SEC.

REVIEW OF SANCTIONS ENTERED BY SELF-REGULATORY BODIES

In *Allan v. Securities and Exchange Commission*,⁹⁶ the plaintiff, a former registered representative of a member of the New York Stock

94. 564 F.2d at 784.

95. *Id.*

96. 577 F.2d 388 (7th Cir. 1978).

Exchange,⁹⁷ attempted to stay a sanction imposed on him by the N.Y.S.E. The Seventh Circuit affirmed the district court's dismissal based on its lack of jurisdiction and sustained the refusal by the SEC to stay the sanctions of the N.Y.S.E. pending SEC review.

The petitioner, Allan, was a vice president and registered account representative with Dean Witter & Co.,⁹⁸ a broker-dealer in securities registered with the SEC and a member of the N.Y.S.E. During the annual audit of Dean Witter, approximately \$10,000 in principal amount of bearer bonds which had been purchased for the account of a customer and a Dean Witter check in the amount of \$162.50 representing interest on the bearer bonds, were discovered to have been misappropriated.⁹⁹ Allan was questioned about this matter and within a short period of time, he admitted misappropriating the bonds and forging the check. He was then discharged by Dean Witter.

Approximately a week later, Allan was hired by Loewi and Co., also a broker-dealer in securities registered with the SEC and member of the N.Y.S.E. Allan's application for qualification as a registered representative with Loewi was "conditionally approved" subject to the outcome of the N.Y.S.E.'s investigation into the circumstances surrounding Allan's termination by Dean Witter.¹⁰⁰

A year later, after formal proceedings before a N.Y.S.E. hearing panel, the panel voted that Allan be permanently barred from employment in any capacity with any member of the N.Y.S.E. The panel's decision was appealed to the N.Y.S.E. board of directors which, after a hearing, upheld the sanction.¹⁰¹

Allan then appealed the N.Y.S.E. decision to the SEC, and also requested a stay of the sanction pending the outcome of his appeal.¹⁰² Within two weeks after Allan sought the stay, the SEC denied Allan's request. Within another week and a half, the SEC denied Allan's renewed request for a stay.¹⁰³

Allan then brought an action in the district court seeking an order requiring the SEC to stay the sanction imposed by the N.Y.S.E. pending the SEC's consideration of his appeal. Allan also filed a petition

97. Hereinafter referred to as N.Y.S.E.

98. Hereinafter referred to as Dean Witter.

99. 577 F.2d at 390.

100. *Id.*

101. *Id.*

102. Section 19(d)(2) of the 1934 Act, 15 U.S.C. § 78s(d)(2) (1976), provides in pertinent part:

Application to such appropriate regulatory agency for review . . . shall not operate as a stay of such action unless such appropriate regulatory agency otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay

103. 577 F.2d at 391.

with the United States Court of Appeals for the Seventh Circuit seeking review of the SEC's denial under section 25(a)(1) of the 1934 Act.¹⁰⁴

The district court dismissed Allan's complaint for lack of jurisdiction on the ground that section 25(a)(1) of the 1934 Act precluded jurisdiction in the district court. The Seventh Circuit affirmed.¹⁰⁵ In view of the plain meaning of section 19(d)(2) of the 1934 Act,¹⁰⁶ the Seventh Circuit had no problem reaching the conclusion that, for Allan to merit entry by the district court of the order he sought, he would have to demonstrate that the SEC had in effect flouted the will of Congress or otherwise abused its discretion. After reviewing the facts, the Seventh Circuit held that Allan had not done so. In discussing the SEC's discretion under section 19(d)(2), Judge Miller stated: "[W]e do not believe a court should try to outguess the expertise of the administrative agency in determining when protection of the investing public requires that a stay of sanctions be denied."¹⁰⁷

The court also denied Allan's petition for direct review in the Seventh Circuit of the SEC's denial of a stay. The court relied on section 25(c)(2) of the 1934 Act which provides in pertinent part:

The filing of a petition under this section does not operate as a stay of the Commission's order or rule. Until the court's jurisdiction becomes exclusive, the Commission may stay its order or rule pending judicial review if it finds that justice so requires.¹⁰⁸

The Seventh Circuit held simply that this section relates to stays of final orders or rules of the SEC and that the SEC's denial of Allan's request for a stay of the N.Y.S.E. sanction was not a final order or rule. Judge Miller also stated that "in the absence of extraordinary circumstances not present here," the SEC's denial of the stay was not reviewable by the Seventh Circuit.¹⁰⁹

The Seventh Circuit properly denied Allan's attempts to seek judicial review of the SEC's denial of the stay. The SEC has broad discretion to stay—it can act "summarily" or only after notice and hearing. There is no substantive standard set forth in section 19(d)(2) of the 1934 Act governing the SEC's exercise of that discretion. Absent such a standard or abuse of discretion, the SEC's determination as to whether

104. Section 25(a)(1) of the 1934 Act, 15 U.S.C. § 78y(a)(1) (1976), provides in pertinent part:

A person aggrieved by a final order of the Commission . . . may obtain review of the order in the United States Court of Appeals for the circuit in which he resides

105. The Seventh Circuit's opinion was written by Judge Miller, Judge of the United States Court of Customs and Patent Appeals sitting by designation. 577 F.2d at 389.

106. 15 U.S.C. § 78s(d)(2) (1976).

107. 577 F.2d at 392.

108. 15 U.S.C. § 78y(c)(2) (1976).

109. 577 F.2d at 393.

or not to enter a stay should be honored. This result is consistent with an orderly review of sanctions entered by the N.Y.S.E. and other self-regulatory bodies subject to review by the SEC.

CONCLUSION

Although this term was a relatively quiet one in the Seventh Circuit, the court did address one clearly important question and some other potentially significant issues. In *Wright*, the Seventh Circuit evidenced its willingness to go beyond the general rule of returning the parties to the *status quo ante* in fashioning relief for violations of the antifraud provisions of the securities laws.

In *Hirk*, the court reaffirmed its narrow interpretation of the "common enterprise" requirement for finding an "investment contract" within the statutory definitions of a "security." Unlike the majority of the lower federal courts, the Seventh Circuit emphasized the importance of the nature of the relationship among the investors rather than the nature of the relationship between the investor and the broker. This narrow interpretation has left a gap in the congressional attempt to protect securities investors.

In addition, in *Mather's Fund*, the Seventh Circuit dismissed the claim of a registered investment company on the basis that the company had failed to allege facts showing it was within the class to be protected by the Investment Company Act of 1940. In *Allen*, the final opinion discussed in this article, the Seventh Circuit reviewed the SEC's refusal to stay sanctions entered by a self-regulatory body. The Seventh Circuit held that district court review of the SEC's denial was limited to those situations in which the SEC has abused its discretion and that direct review by the United States Circuit Courts of Appeals was restricted to final orders or rules of the SEC.

