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## SECURITIES LAW: IMPLIED PRIVATE ACTIONS AND BROKER "CHURNING" HIGHLIGHT THE TERM

JOHN C. WALDEN\*

In the 1983-84 term, the U.S. Court of Appeals for the Seventh Circuit contributed significantly to the field of securities law. The court decided eight securities cases during the term, involving the general areas of implied private rights of action, fraudulent conduct in connection with transactions in securities, beneficial ownership and liability for short-selling profits, and the definition of investment advisor under the Investment Advisors Act.

The Seventh Circuit's decisions involving implied private rights of action under the Securities Exchange Act of 1934<sup>1</sup> (1934 Act) were particularly noteworthy. In one case,<sup>2</sup> the court examined section 7(d) and Regulation U, which impose reporting requirements on a bank which accepts margin stock as security for a loan. The court found, by inquiring into the congressional intent underlying the statute, that no private remedy existed for the borrower against the lending bank.<sup>3</sup> This case was the Seventh Circuit's first review of private rights under section 7(d), and the first circuit-level application of the Supreme Court's recently announced congressional intent analysis under section 7(d). In another case of first impression,<sup>4</sup> the Seventh Circuit recognized the implied right of a corporation to obtain injunctive relief against a purchaser of the corporation's shares for violation of section 13(d)'s disclosure provisions. The court based its conclusion that Congress intended to create a private right of action under section 13(d) on a unique examination of the legal context surrounding the enactment of the provision.<sup>5</sup>

The most significant decision<sup>6</sup> of the 1983-84 term arose under the anti-fraud provisions of the 1934 Act; section 10(b) and Rule 10b-5. The Seventh Circuit held that a broker's violation of the trading parameters of a customer's options account constituted improper "churning" under

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1. Hereinafter referred to as the 1934 Act.

2. *Bassler v. Central National Bank in Chicago*, 715 F.2d 308 (1983).

3. See *infra* notes 21-35 and accompanying text.

4. *Indiana National Corp. v. Rich*, 712 F.2d 1180 (1983).

5. See *infra* notes 36-52 and accompanying text.

6. *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361 (1983).

Rule 10b-5.<sup>7</sup> In this decision the court announced a new, broader definition of "churning" and relaxed the evidentiary standards traditionally employed to establish the offense.

This note will review the eight securities cases decided by the Seventh Circuit during its 1983-84 term. A brief perspective will be offered for each case in order to place the case in the context of other related decisions, and, where appropriate, a decision's potential impact will be assessed.

### IMPLIED PRIVATE RIGHTS OF ACTION

The Seventh Circuit had opportunity in the 1983-84 term to decide, under three different sections of the 1934 Act, whether to grant complainants relief when the provisions of the statute were silent as to private remedies. Because the law of implied private actions under the securities laws has evolved rapidly, it is helpful to briefly trace its development prior to reviewing the cases in the Seventh Circuit.

#### *Background*

The Supreme Court first addressed the question of implied rights of action under the 1934 Act in 1964 in *J.I. Case Co. v. Borak*.<sup>8</sup> In *Borak*, a shareholder sued the corporation for a violation of the proxy rules contained in section 14(a).<sup>9</sup> In holding that there was an implied right of action, the Court found that section 14(a) had explicit language indicating a congressional purpose to protect investors from misleading proxy statements. This purpose created a duty in favor of investors as a class, and a breach of the duty could be actionable by the investor.

Since *Borak*, the Supreme Court has gradually modified its general standard for implying private remedies. In 1974, the Court held that

7. See *infra* notes 88-105 and accompanying text.

8. 377 U.S. 426 (1964). Borak, the plaintiff, a shareholder of defendant J.I. Case Co., brought a derivative suit alleging that Case distributed a misleading proxy statement which resulted in shareholder approval of a merger. *Id.* at 429-30. Borak sought private damages and an injunction voiding the merger. *Id.* at 430.

9. *Id.* Section 14(a) provides in pertinent part:

It shall be unlawful for any person . . . in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security.

15 U.S.C. § 78n(a) (1976) (emphasis supplied). Specifically, Borak addressed private rights under S.E.C. Rule 14a-9, promulgated under section 14(a), which provides in pertinent part:

No solicitation . . . shall be made by means of any proxy statement . . . which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact.

17 C.F.R. § 240.14a-9 (1981).

where a statute's legislative history and express language refer only to non-private remedies, no private action could be inferred.<sup>10</sup> One year later, the Court established the requirement that a private action be necessary to further the purpose of the statute.<sup>11</sup> These modifications of the criteria for implying private remedies left the lower courts confused. This confusion was largely resolved in *Cort v. Ash*<sup>12</sup> when the Supreme Court identified four factors to be considered in determining the existence of a private right of action: 1) whether the plaintiff was a member of a class for whose especial benefit the legislation was enacted; 2) whether there was any indication, explicit or implicit, of a legislative intent either to create or deny a private remedy; 3) whether implication of a private right was consistent with the underlying purposes of the legislative scheme; and 4) whether the cause of action was one traditionally relegated to state law so that it would be inappropriate to infer a claim based on federal law. Unfortunately, the Court did not indicate the comparative weight to be accorded each of these factors in the inquiry as to the existence of an implied private right of action.

Recently, the Supreme Court has begun to redefine its explicit point-by-point *Cort* analysis by limiting its inquiry to congressional intent; the second *Cort* factor. In *Piper v. Chris-Craft Industries, Inc.*,<sup>13</sup> the Court stated that the four factors of *Cort* were relevant but not determinative of the existence of a private right of action.<sup>14</sup> The *Piper* court instead looked only to legislative history as an indication of congressional intent to imply or deny a private action. The *Piper* rationale was extended in *Touche Ross & Co. v. Redington*,<sup>15</sup> where the Supreme Court examined the statute's legislative history, explicit language, and purpose as indica-

10. See *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453, *reh'g denied*, 415 U.S. 952 (1974) [*Amtrak* case]. Plaintiff passengers sought to enjoin the discontinuance of certain passenger trains claiming that such discontinuance violated the Rail Passenger Service Act, 45 U.S.C. § 547(a) (1970).

11. *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 421 (1975). A brokerage customer sought a district court order for the S.E.C. and the Security Investor Protection Corp. to begin liquidation of a troubled brokerage firm. *Id.* at 414. The action was brought under the Security Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78ggg (1970).

12. 422 U.S. 66 (1975). The plaintiff in *Cort*, a stockholder, sought private damages from the corporation's directors for violation of a federal criminal statute, 18 U.S.C. § 610 (1970 & Supp. III 1973) (repealed 1976). The statute prohibited corporations from making campaign contributions in certain elections. 422 U.S. at 68.

13. 430 U.S. 1, *reh'g denied*, 430 U.S. 976 (1977). The plaintiff, Chris-Craft Industries, Inc., attempted to gain control of the defendant Piper Aircraft Co. through a cash tender offer. Chris-Craft sought damages for Piper's alleged misleading statements under section 14(e) of the 1934 Act. *Id.* at 59. Section 14(e) provides in pertinent part: "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact . . . in connection with any tender offer . . ." 15 U.S.C. § 78n(e).

14. *Id.* at 37.

15. 442 U.S. 560 (1979). The issue was whether customers of a securities brokerage firm had an

tive of congressional intent. Justice Rehnquist stated in *Touche Ross* that although *Cort* provided four "relevant" factors to be considered in determining whether a private remedy is implicit in a statute, each factor should not receive equal weight.<sup>16</sup> The Court's role was limited "solely to determining whether Congress intended to create a private right of action."<sup>17</sup> Most recently, in *Merrill Lynch, Pierce, Fenner & Smith v. Curran*,<sup>18</sup> the Supreme Court reaffirmed *Piper*, giving only perfunctory attention to the *Cort* analysis and instead relying wholly on legislative construction.<sup>19</sup>

In 1982, the Seventh Circuit adopted the Supreme Court's approach of looking to congressional intent to imply private remedies.<sup>20</sup> In the 1983-84 term, three cases gave the Seventh Circuit the opportunity to employ this approach.

*Borrowers Remedies Under Section 7(d)*—*Bassler v. Central National Bank in Chicago*

To monitor the practice of borrowing funds for the purpose of speculating in securities, the Federal Reserve Board enacted Regulation U under authority of section 7(d) of the 1934 Act.<sup>21</sup> Regulation U requires

implied cause of action against the audit accountants for inaccuracies in the financial reports of the firm. The action was brought under section 17(a) of the 1934 Act, which provides in pertinent part:

Every national securities exchange, every member thereof, . . . and every broker or dealer registered pursuant to . . . this title should make, keep, and preserve for such periods, such accounts, correspondence, . . . and other records, and make such reports, as the [Securities and Exchange] Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78q(a) (1970).

16. 442 U.S. at 575.

17. *Id.* at 568.

18. 456 U.S. 353 (1982). In *Curran*, the Court consolidated four separate claims for private relief under the Commodity Exchange Act. One claim was brought by an investor in commodity futures contracts against his broker for violations of the anti-fraud provisions; 7 U.S.C. § 6(a) (1976 ed. and Supp. IV). 456 U.S. at 360. Three actions were brought by speculators in futures contracts against the New York Mercantile Exchange, its officials, and futures commission merchants, claiming damages resulting from unlawful price manipulation that allegedly could have been prevented by the Commodity Futures Exchange Commission's enforcement of its own rules. 456 U.S. at 369. This action was commenced under section 4(b) of the CEA; 7 U.S.C. § 6(b) (1976 ed. and Supp. IV). 456 U.S. at 369 n.42.

19. The *Curran* court conducted a unique analysis of the contemporary legal context in which the CEA provisions were enacted, and found that Congress intended to create private rights of action. *Id.* at 374-95. For a discussion of such an analysis, see *infra* notes 40-46 and accompanying text.

20. See *Barany v. Buller*, 670 F.2d 726 (7th Cir. 1982); *Allison v. Liberty Savings*, 695 F.2d 1086 (7th Cir. 1982).

21. Section 7(d) of the 1934 Act provides in pertinent part:

It shall be unlawful for any person . . . to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board of Governors of the Federal

banks to secure a Federal Reserve Form U-1, or Purpose Statement, from all borrowers using margin stock as security for loans. In *Bassler v. Central National Bank in Chicago*,<sup>22</sup> the Court of Appeals for the Seventh Circuit considered and rejected a borrower's claim for private relief under Regulation U and section 7(d).

The plaintiff, Bassler, had entered into a series of loan transactions with the defendant, Central National Bank, to finance Bassler's purchase of Rochelle Bank and Trust Company stock. Bassler executed and delivered promissory notes and pledged Rochelle stock as security for the notes. Central failed to obtain from Bassler the Purpose Statement, required by Regulation U whenever an extension of credit is secured by stock. When Bassler later discovered that the Rochelle stock was worthless, he claimed that Central's violation entitled him to void his loan contract.<sup>23</sup> The district court dismissed the action, finding that Bassler had no private remedy under section 7(d).<sup>24</sup> The Seventh Circuit affirmed the dismissal.<sup>25</sup>

The *Bassler* court started its analysis by declaring that in the post-*Cort* era, the question of the existence of an implied private right of action under section 7 must be answered by ascertaining congressional in-

Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. 15 U.S.C. § 78g(d) (1982). Regulation U provides in pertinent part:

In connection with an extension of credit secured directly or indirectly by any margin stock, the bank shall obtain . . . a statement in conformity with the requirements of Federal Reserve Form U-1 executed by the recipient of such extension of credit (sometimes referred to as the "customer") and executed and accepted in good faith by a duly authorized officer of the bank prior to such extension . . . . 15 C.F.R. § 221.3 (1984).

22. 715 F.2d 308 (7th Cir. 1983).

23. *Id.* at 309. Bassler contended for the first time on appeal that section 7(d) should be construed in the context of the whole 1934 Act, and specifically section 29(b). *Id.* n.5. He urged that section 29(b) made the loan contract voidable at his option. *Id.* at 309. Section 29(b) provides in pertinent part:

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made . . . 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 . . . of such contract was in violation of any such provision, rule, or regulation. . . .

15 U.S.C. § 78cc(b) (1982). Bassler also alleged that Central was aware of the worthlessness of Rochelle stock at the time of the loan, and thereunder violated section 10(b) of the 1934 Act, and S.E.C. Rule 10b-5, by failing to disclose the worthlessness to Bassler. 715 F.2d at 309. The district court held that Bassler failed to allege facts from which Central's duty to disclose could be inferred. *Id.* The Court of Appeals for the Seventh Circuit reversed and remanded as to this count, finding that Bassler's complaint was broad enough to allow proof of Central's duty. *Id.* (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Chiarella v. United States*, 445 U.S. 222, 230 (1980)).

24. 715 F.2d at 309.

25. *Id.* at 313.

tent.<sup>26</sup> In its searching for this intent, the court first examined the purpose of section 7, and whether that purpose was to protect individual investors such as Bassler. The court noted that section 7(d) authorizes the Federal Reserve Board to prescribe regulations "to prevent the excessive use of credit for the purchasing or carrying of or trading in securities."<sup>27</sup> Because borrowing investors are the users of credit, it is their conduct at which the statute is aimed.<sup>28</sup> Furthermore, although section 7(d) proscribes the failure of lenders to obtain Regulation U statements, section 7(f) makes it unlawful for the individual investor to obtain credit in a transaction in which they fail to provide the lender with a Regulation U statement.<sup>29</sup> The *Bassler* court reasoned that Congress would not have enacted 7(f) if the purpose underlying section 7 was the protection of individual investors.<sup>30</sup>

An additional factor considered by the *Bassler* court in searching for congressional intent was the legislative history and statutory scheme behind section 7(d). Section 7(d) was an original provision of the 1934 Act. The court found that the Act was passed to promote the nation's financial health and stabilize the credit markets, rather than to protect the individual investor.<sup>31</sup> Although the Act may, as a byproduct, protect individual investors, this was not its primary purpose.<sup>32</sup> The court therefore was unwilling grant a private remedy under section 7(d).<sup>33</sup>

26. *Id.* at 310. The *Bassler* court stated that "of the four factors enunciated in *Cort*, the second—whether there is any indication of Congressional intent, explicit or implicit, to create or deny a private remedy—is the key." *Id.*

27. *Id.* at 310-11 (emphasis added) (quoting section 7(d); 15 U.S.C. § 78g(d) (1981)). See also note 21 *supra*.

28. *Id.*

29. *Id.* Section 7(f) provides in pertinent part:

It is unlawful for any United States person . . . to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited . . . .

15 U.S.C. § 78g(f) (1982).

30. 715 F.2d at 311.

31. *Id.* at 313 (citing *House Comm. on Interstate and Foreign Commerce, Report on H.R. 9323*, H.R. REP. No. 1383, 73d Cong., 2d Sess. 8 (1934)).

32. 715 F.2d at 313.

33. The *Bassler* court additionally discussed Bassler's argument that the language of section 29(b) of the 1934 Act, which voids all contracts made in violation of the Act, see *supra* note 24, conferred a private action under section 7(d). Bassler relied upon the Supreme Court's recent decision in *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979), wherein section 215 of the Investment Advisors Act, which has language comparable to that of section 29(b) of the 1934 Act, was held to imply a private remedy under the anti-fraud provisions of the Investment Advisors Act. *TAMA* was silent as to whether the language of section 215 alone was sufficient to imply a right of action. The *Bassler* court interpreted *TAMA* to hold that language alone was insufficient to create a private remedy without other independent clues of congressional intent. 715 F.2d at 312. The *Bassler* court found that Bassler presented no such clues with respect to section 7

In *Bassler*, the Seventh Circuit conducted an examination of legislative intent to imply a private remedy, looking to the purpose of section 7(d), its language and the language of other pertinent provisions, and the legislative history underlying the regulation's enactment. The court's inquiry was in line with recent Supreme Court decisions which focused on congressional intent rather than the four factors enunciated in *Cort*.<sup>34</sup> Moreover, *Bassler* represented the Seventh Circuit's first review of private remedies under section 7, and brought the Seventh Circuit's law into accord with that of other circuits which had considered the issue.<sup>35</sup>

*Corporation's Right to Injunctive Relief Under Section 13(d)*—Indiana National Corp. v. Rich

*Indiana National Corp. v. Rich*<sup>36</sup> presented the Seventh Circuit with another opportunity to apply the congressional intent analysis to implication of private relief. *Indiana National* involved section 13(d) of the 1934 Act, which requires any person acquiring more than five percent of a class of registered securities of a corporation to send a disclosure statement to the issuer, the markets on which the stock is traded and the S.E.C.<sup>37</sup> In *Indiana National*, the Seventh Circuit found an implied right of action under section 13(d) for an issuer corporation to seek injunctive relief from a purchaser's violation of the 13(d) disclosure provisions.<sup>38</sup>

The plaintiff, Indiana National Corporation, was a bank holding company engaged principally in banking through its wholly owned subsidiary, Indiana National Bank. Defendants were a group of investors

of the 1934 Act, and therefore the language of section 29(b) was insufficient to imply a private remedy under section 7(d). *Id.*

34. See *supra* notes 12-19 and accompanying text.

35. Other circuits had considered the issue and preceded *Bassler* in denying section 7 relief, however all had applied the *Cort* analysis. See, e.g., *Walck v. American Stock Exchange, Inc.*, 687 F.2d 778 (3d Cir. 1982), *cert. denied*, 459 U.S. 829 (1983) (Regulation T); *Gilman v. Federal Deposit Insurance Corp.*, 660 F.2d 688 (6th Cir. 1981) (Regulation U); *Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 644 F.2d 1194 (6th Cir. 1981), *cert. denied*, 455 U.S. 909, *reh'g denied*, 455 U.S. 1008 (1982) (Regulation T); *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073 (4th Cir. 1979) (Regulation T); *Utah State University of Agriculture and Applied Science v. Bear, Stearns & Co.*, 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977) (Regulation T). *Bassler*, then, was the first review of section 7 private remedies applying the Supreme Court's new analysis of congressional intent. It is questionable, however, whether the shift from *Cort* to the new analysis has any impact on implication or denial of private remedies.

36. 712 F.2d 1180 (7th Cir. 1983).

37. Section 13(d) provides in pertinent part:

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall . . . send to the issuer of the security . . . and file with the [Securities and Exchange] Commission, a statement. 15 U.S.C. § 78m(d) (1982).

38. 712 F.2d at 1185.



who, after acquiring more than five percent of Indiana National's stock, filed a Schedule 13D as required by section 13(d). Indiana National instituted an action alleging that the Schedule 13D contained materially false and misleading information, in violation of section 13(d). The district court dismissed the action, finding that when explicit remedies such as S.E.C. action are provided in a statute, and no private remedies are included, Congress must have intended that no private remedies exist.<sup>39</sup> The Court of Appeals for the Seventh Circuit reversed.

The Seventh Circuit based its reversal on an analysis of the contemporary legal context in which section 13(d) was enacted. This analysis was first applied by the Supreme Court in *Cannon v. University of Chicago*<sup>40</sup> as a means of determining congressional intent behind the enactment of a statute. It provides that where Congress acts in a statutory context in which private remedies have already been recognized by the courts, a presumption is created that Congress was aware of the remedies at the time the new statute was enacted. Therefore, Congress' failure to explicitly provide for private remedies in the statute should be construed as an intent that they be awarded in conformity with judicial precedents.

In analyzing the legal context behind the enactment of section 13(d), the *Indiana National* court examined the history of the Williams Act, of which section 13(d) is a part. The Williams Act was enacted in 1968 in response to the growing use of cash tender offers as a means for achieving corporate takeovers.<sup>41</sup> The purpose of the Williams Act was to ensure that public shareholders faced with a cash tender offer were not forced to decide upon the offer without adequate information about the qualifications and intentions of the offering party.<sup>42</sup> These assurances already existed for shareholders confronted with proxy solicitations or exchange offers;<sup>43</sup> two other forms of corporate takeover. The Williams Act, then,

39. *Id.* at 1184 (citing *Gateway Industries, Inc. v. Agency Rent A Car, Inc.*, 495 F. Supp. 92 (N.D. Ill. 1980)).

40. 441 U.S. 677 (1979). In *Cannon* the Supreme Court found an implied private action under Title IX of the Education Amendments of 1972. *Id.* at 696-99. The Court reasoned that Title IX was patterned after Title VI of the Civil Rights Act of 1964 and was enacted at a time when Title VI had been construed as creating a private remedy. *Id.* at 694-703. The *Cannon* court concluded that Congress was aware of judicial implications of private remedies under Title VI, and therefore expected Title IX to be interpreted in line with those precedents. *Id.* at 696-99. See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); *Herman & MacLean v. Huddleston*, 103 S. Ct. 683 (1983).

41. 712 F.2d at 1183 (citing *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, *reh'g denied*, 430 U.S. 976 (1977)).

42. *Id.* (citing *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967)).

43. See 15 U.S.C. §§ 78n, 77e (1976).

and section 13(d) specifically, was patterned after the proxy rules contained in section 14(a) of the 1934 Act.

At the time the Williams Act was enacted, section 14(a) had already been found to establish an implied private right of action for an issuer corporation.<sup>44</sup> The *Indiana National* court concluded that Congress was aware of the judicial precedent of awarding 14(a) private remedies when it enacted the Williams Act.<sup>45</sup> Therefore, according to the Supreme Court's *Cannon* analysis, silence as to remedies in 13(d) reflects legislative intent to retain a private remedy for an issuer corporation, which had previously been awarded under 13(d)'s prototype, section 14(a).<sup>46</sup>

The *Indiana National* court further supported its implication of a section 13(d) private remedy with a finding that private enforcement was necessary to make the section 13(d) disclosure requirements effective.<sup>47</sup> The S.E.C., the trading markets and the issuer corporation are the only parties to receive the Schedule 13D when filed.<sup>48</sup> The S.E.C., in a brief *amicus curiae*, urged that it was too overburdened with Schedule 13D disclosures to police possible violations. Therefore, the court reasoned that the only party with both the capability and incentive to ensure accurate filings was the issuer corporation.<sup>49</sup>

*Indiana National* was the Seventh Circuit's first review of a corporation's right to injunctive relief under section 13(d). The decision overturned two previous district court decisions,<sup>50</sup> and brought the Seventh Circuit's law into line with the law in all other circuits which had considered the issue.<sup>51</sup> Consistent with the recent trend,<sup>52</sup> the court looked to congressional intent as dispositive of the existence of a private remedy. However the court departed from the traditional examination of the purpose, language and history of the statute and instead analyzed the con-

44. 712 F.2d at 1183 (citing *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966); *General Time Corp. v. Talley Industries, Inc.*, 430 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969)).

45. 712 F.2d at 1183.

46. *Id.* In further support of its legal context analysis, the *Indiana National* court noted that the Williams Act had twice been amended, and on both occasions Congress opted to leave the issuer corporation's private remedy intact. The *Indiana National* Court interpreted this silence as an affirmative intent to preserve the private right of issuer corporations under section 13(d). *Id.* at 1184.

47. *Id.*

48. *See supra* note 37.

49. 712 F.2d at 1184.

50. *See Gateway Industries, Inc. v. Agency Rent A Car, Inc.*, 495 F. Supp. 92 (N.D. Ill. 1980); *Sta-Rite Industries, Inc. v. Nortek, Inc.*, 494 F. Supp. 358 (E.D. Wis. 1980).

51. *See GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971); *General Aircraft Corp. v. Lampert*, 556 F.2d 90 (1st Cir. 1977); *Chromalloy American Corp. v. Sun Chemical Corp.*, 611 F.2d 240 (8th Cir. 1979); *Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216 (4th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981).

52. *See supra* notes 10-19 and accompanying text.

temporary legal context behind the statute's enactment. Although unique among courts which have analyzed private actions under section 13(d), the Seventh Circuit's departure was in line with recent Supreme Court decisions which have applied the contemporary legal context analysis in other statutory settings.

*Shareholder's Right to Damages Under Rule 14a-7—  
Haas v. Wieboldt Stores, Inc.*

Prior to a vote of a corporation's shareholders, each shareholder receives proxy materials, sent by other interested shareholders and the issuer, which contain solicitations for the shareholders' votes. Rule 14a-7,<sup>53</sup> promulgated under section 14(a) of the 1934 Act,<sup>54</sup> provides that when a shareholder tenders proxy materials to the corporation for mailing to other shareholders, the corporation must mail the materials within a reasonable time. In *Haas v. Wieboldt Stores, Inc.*,<sup>55</sup> the Seventh Circuit addressed the narrow question of whether a stockholder has an implied private action under Rule 14a-7 for the corporation's failure to timely mail the proxy materials. The court held that such a remedy was available.

The plaintiff Haas was a shareholder of Wieboldt Stores, Inc., and desired to be elected to its Board of Directors. Wieboldt management opposed Haas' election. Haas requested from Wieboldt a shareholder list so that he could mail his proxy solicitation materials. Wieboldt refused to provide the list, and instead opted to mail the proxy materials to the shareholders itself, as it was entitled to do.<sup>56</sup> On the day that Haas delivered his materials to Wieboldt, Wieboldt changed the date for the shareholder meeting for the apparent purpose of discouraging Haas' election. This change caused Haas' materials to be inaccurate, and enabled Wieboldt to refuse to mail them.<sup>57</sup> Haas sought damages under Rule 14a-7 for the expense of preparing his proxy materials.

The *Haas* court relied solely upon the Supreme Court's 1964 deci-

53. Rule 14a-7 provides in pertinent part: "Copies of any proxy statement, form of proxy or other communication furnished by the security holder shall be mailed by the issuer to such of the holders of record . . . as the security holder shall designate." 17 C.F.R. § 240.14a-7 (1984).

54. See *supra* note 9.

55. 725 F.2d 71 (7th Cir. 1984).

56. *Id.* at 72. A corporation has an option when confronted with a stockholder who desires to solicit proxies. The corporation may either provide the solicitor with a list of all shareholders, or mail the proxy materials itself at its own expense. See 17 C.F.R. § 240.14a-7 (1984) (Rule 14a-7).

57. *Id.* A corporation may refuse to mail a shareholder's proxy materials that violate section 14(a). See *Rosenblatt v. Northwest Airlines, Inc.*, 435 F.2d 1121, 1125 (2d Cir. 1970). Haas' materials were false and misleading, in violation of Rule 14a-9, so Wieboldt could refuse to mail them. For the pertinent text of Rule 14a-9, see *supra* note 9.

sion in *J.I. Case Co. v. Borak*.<sup>58</sup> In *Borak* the Court declared that under Rule 14a-9, which forbids the mailing of misleading proxy materials, a shareholder can bring a private action against the corporation.<sup>59</sup> The *Haas* court reasoned that the same harm of stockholder misinformation is caused by a corporation's mailing of misleading proxy materials as is caused by a corporation's failure to mail proxy materials, a Rule 14a-7 violation. Therefore, because both rules have the purpose of preventing stockholder misinformation, the court summarily announced that both rules should contain the private remedy announced in *Borak*.<sup>60</sup>

Although the Seventh Circuit's outcome in *Haas* is sound, its reliance on *Borak* is questionable. *Borak* was decided under a much broader standard for implying private remedies than the Supreme Court has since applied. Justice Rehnquist commented in *Touche Ross & Co. v. Redington*<sup>61</sup> that "in a series of cases since *Borak* [the Supreme Court has] adhered to a *stricter standard* for implication of private causes of action," and that stricter standard is followed today.<sup>62</sup> This makes clear that the *Borak* standard is no longer applicable. Accordingly, the *Haas* court's analogy of the purpose of Rule 14a-7 to that of Rule 14a-9, under the assumption that a private remedy for 14a-9 exists under *Borak*, is unconvincing. Rather than relying on *Borak*, the *Haas* court should have re-examined section 14(a) under the current standard; whether there is indication of legislative intent to imply or deny a private remedy. Such an analysis, although likely to reaffirm the *Borak* result, would have supported the result with current law.

Aside from the issue of implying private remedies, *Haas* is noteworthy for the court's interpretation of Rule 14a-7. The rule provides that "Copies of any proxy statement, form of proxy or other communication furnished by the security holder shall be mailed by the issuer to such holders of record . . . as the security holder shall designate."<sup>63</sup> The *Haas* court reasoned that although refusal to mail false materials is generally excused, it should not be excused when the corporation itself has caused the materials to be false.<sup>64</sup> The Seventh Circuit, therefore, announced in *Haas* that a corporation's refusal to mail a shareholder's proxy materials, which were made false by the deliberate efforts of the

58. 377 U.S. 426 (1964).

59. 725 F.2d at 73. See also *supra* note 9 and accompanying text.

60. 725 F.2d at 73.

61. 442 U.S. 560 (1979). For a discussion of *Touche Ross*, see *supra* notes 16-18 and accompanying text.

62. 442 U.S. at 578 (emphasis added).

63. 17 C.F.R. § 240.14a-7 (1984).

64. 725 F.2d at 73.

corporation to prevent the mailing, is a prima facie violation of Rule 14a-7.<sup>65</sup>

### FRAUDULENT REPRESENTATIONS UNDER SECTION 10(b) AND RULE 10b-5

Section 10(b) of the 1934 Act,<sup>66</sup> and Rule 10b-5 promulgated thereunder,<sup>67</sup> have been frequent areas of litigation. They provide a cause of action for plaintiffs who suffer an injury as a result of manipulation or deception in connection with the sale of securities. During the 1983-84 term, the Seventh Circuit decided two cases under these anti-fraud provisions.

#### *Generous Grant of a Federal Remedy— Norris v. Wirtz*

Misrepresentations are actionable under section 10(b) and Rule 10b-5 only if made "in connection with" the purchase or sale of a security. In *Norris v. Wirtz*,<sup>68</sup> the Seventh Circuit considered whether this requirement was satisfied where a Trustee misrepresented to a trust beneficiary the market value of securities held in the trust. Because the misrepresentations were made in securing the beneficiary's necessary approval for the sale of the securities, they satisfied the "in connection with" requirement.

The plaintiff, Susan Norris, was the beneficiary of her father's testamentary trust. William Wirtz was trustee, and William Wirtz's father, Arthur Wirtz, was named as successor trustee. The trust property in-

65. *Id.* The *Haas* court discussed this issue in the context of an argument that Haas' complaint stated no cause of action upon which relief could be granted. This issue was separate from the question of implied private remedies, but the court chose to discuss both arguments due to confusion in the district court's basis for judgment. *Id.* at 71.

66. Section 10(b) provides in pertinent part:

It shall be unlawful for any person, directly or indirectly . . . [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 [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1982).

67. Rule 10b-5 provides in pertinent 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 of any security.

17 C.F.R. § 240.10b-5 (1984).

68. 719 F.2d 256 (1983), *cert. denied*, 104 S. Ct. 1713 (1984).

cluded the minority stock interest in three closely-held companies: St. Louis Arena Corporation; Arena Bowl, Inc.; and Judge & Dolph, Ltd. William Wirtz was President and Director and Arthur Wirtz was Chairman of the Board of Directors of each of the three companies. The controlling shareholder in each of the companies was the Wirtz Corporation, which was owned by William and Arthur Wirtz.

The terms of the trust granted the trustee full power to sell, exchange or pledge any or all of the trust property as he deemed proper.<sup>69</sup> The trust further allowed the "individual Trustee" to purchase any securities held in the trust, provided that he have the prior approval of Susan Norris.<sup>70</sup> The Wirtzes secured Susan Norris' written approval for the St. Louis Arena Corporation and Arena Bowl, Inc. to redeem their shares of stock which were held in the trust. The Wirtzes also received Norris' approval for the Wirtz Corporation to purchase the shares of Judge & Dolph, Ltd. from the trust. Neither purchase was to be made by the individual trustee William Wirtz. These transactions were routinely approved by the probate court, and when executed effectively brought the three companies under the sole control of William and Arthur Wirtz.

Susan Norris alleged that the Wirtzes and their associated companies made misrepresentations to her regarding the fair price of the shares sold from the trust, thereby fraudulently securing her approval of the transactions in violation of section 10(b) and Rule 10b-5.<sup>71</sup> The district court dismissed the claim, holding that the trust gave Susan Norris no authority to prevent the sale of shares to the corporations themselves, only to William Wirtz individually, and therefore the alleged misrepresentations were not made "in connection with" the sale of securities as required by Rule 10b-5.<sup>72</sup> On appeal, the Seventh Circuit reversed the district court's ruling.

The Seventh Circuit first discussed the threshold issue of Norris' standing to bring her action. The only private plaintiffs who may bring a cause of action under section 10(b) are those who actually buy or sell a

69. "The will establishing the trust states: 'The Trustee shall have full power to . . . sell, exchange or pledge any or all of the trust property as he deems proper . . . for such purposes as the Trustee deems advisable. . . . [T]he decision and judgment of my said Trustee shall be conclusive, binding and final and no present or future income beneficiary shall question the decision or good faith of such Trustee.'" 719 F.2d 256, 261 (1983) (Bauer, J., dissenting).

70. "The will states: 'Nothing herein contained shall be construed to prevent the individual Trustee . . . from becoming a purchaser of any such securities from any available source whatsoever provided he has the approval of the income beneficiaries . . . with respect to such purchase.'" *Id.*

71. *Id.* at 258. Section 10(b) and Rule 10b-5 are provided *supra* notes 66-67.

72. The district court below concluded that the Wirtz's misrepresentations were breaches of fiduciary duties, cognizable only under state law rather than federal law. *Id.*

security.<sup>73</sup> This requirement is known as the *Birnbaum* rule.<sup>74</sup> This rule has been relaxed in a number of recent cases which have held that a party who feels the direct impact of a transaction need not actually perform the mechanics of the transaction in order to have standing under section 10(b).<sup>75</sup> Susan Norris, as beneficiary, felt the direct impact of William Wirtz's transactions, and she therefore had standing to bring a claim.<sup>76</sup>

The central issue in *Norris* was whether Susan Norris had authority under the trust to prevent the purchase of stock by the three corporations controlled by William and Arthur Wirtz. If Norris had no such authority, then the alleged misrepresentations had no impact on William Wirtz's power to sell the shares. The misrepresentations, then, would not have been made in connection with the sale of securities, and would not, therefore, have been actionable under Rule 10b-5.<sup>77</sup>

The will provided that Susan Norris must approve only purchases of stock made by the "individual Trustee." The *Norris* court summarily held that this provision applied to any self-dealing transaction, including the purchases made by the closely-held corporations under the control of William and Arthur Wirtz.<sup>78</sup> Therefore, Susan Norris had the power to refuse the transactions and the "in connection with" requirement of Rule 10b-5 was satisfied. The court continued that only such a realistic interpretation of the alleged conduct could further the broad proscription against fraud under section 10(b) and Rule 10b-5.<sup>79</sup>

Judge Bauer dissented from the majority opinion, arguing that the trust agreement gave Susan Norris no power to control the purchase of stock by the three closely-held corporations.<sup>80</sup> Accordingly, he con-

73. *Id.* at 259.

74. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). The *Birnbaum* rule was approved by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975). See also note 82 *infra*.

75. See *Kirshner v. United States*, 603 F.2d 234 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979) (the beneficiaries of a pension trust have standing to sue the pension fund trustees for securities frauds); *James v. Gerber Products Co.*, 483 F.2d 944 (6th Cir. 1973) (the term "purchaser-seller" should be interpreted flexibly in order to protect the investing public and ensure honest securities dealings); *Mallis v. Federal Deposit Insurance Corp.*, 568 F.2d 824 (2d Cir.), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed*, 435 U.S. 31 (1978) (*per curiam*) (pledgees of stock certificates have standing to sue under section 10(b) and Rule 10b-5). See also *O'Brien v. Continental Illinois National Bank & Trust Co.*, 593 F.2d 54 (7th Cir. 1979) (trustees of a pension fund whose assets were managed by a bank *may* have had standing as purchasers to sue the bank for its violations of section 10(b)).

76. 719 F.2d at 259.

77. *Id.* at 259-60.

78. "We think that the only reasonable interpretation of the testamentary provision is that it was intended to prevent any self-dealing transaction, regardless of the form, in which the individual trustee purchased securities beneficially owned by the plaintiff." *Id.* at 260.

79. *Id.* at 261 (citing *Herman & MacLean v. Huddleston*, 103 S. Ct. 683 (1983)).

80. *Id.* at 261-62 (Bauer, J., dissenting).

cluded that the alleged misrepresentations were not made in connection with the sale or purchase of securities, and were not violative of section 10(b) or Rule 10b-5. Furthermore, Judge Bauer urged that *Norris* presented an issue of pure state trust law, which is not contemplated by federal securities laws.

The *Norris* majority emphasized the substance of the Wirtz' self-dealing transactions over their form in interpreting the trust agreement to find a violation of section 10(b) and Rule 10b-5. The court's interpretation was reasonable, and appears just in affording Susan Norris relief. However, the award of a federal remedy seems inconsistent with the recent Supreme Court trend of limiting relief under 10b-5.<sup>81</sup> In the past decade, the Supreme Court has limited the class of plaintiffs allowed to recover under 10b-5,<sup>82</sup> invoked a scienter requirement as an element of the cause of action,<sup>83</sup> and found that allegations of fraud are insufficient without specific allegations of misrepresentation or deception.<sup>84</sup> In the most recent of these decisions, the Court expressly stated that section 10(b) and Rule 10b-5 should not be invoked to remedy a breach of state fiduciary duty.<sup>85</sup> Given the express language of the *Norris* trust, the *Norris* court could easily have found that the Wirtz misrepresentations were not made in connection with the purchase or sale of securities, and

81. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

82. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731, *reh'g denied*, 423 U.S. 884 (1975). The offerees of a stock offering sued the offering corporation, Blue Chip, under section 10(b) for "intentionally [making] the prospectus overly pessimistic in order to discourage [offerees] from accepting what was intended to be a bargain offer, so that the rejected shares might later be offered to the public at a higher price." The *Blue Chip* Court denied recovery by limiting the class of 10(b) plaintiffs to actual purchasers and sellers. The Court's rationale was based on a desire to avoid vexatious litigation arising as a result of the settlement value of specious claims and the potential for abuse of discovery proceedings. *Id.* at 739.

83. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, *reh'g denied*, 425 U.S. 986 (1976). The plaintiff investors alleged that the defendant accounting firm, Ernst & Ernst, was negligent in the preparation of certain reports prepared for the S.E.C., and had the reports been properly prepared, the S.E.C. would have been alerted of a fraudulent investment scheme which resulted in plaintiffs harm. The Court found that Congress intended that a higher standard than negligence be required to create 10(b) liability, and that scienter on the part of Ernst & Ernst must be established. Plaintiffs failed to establish scienter and liability was denied. *Id.*

84. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977). The defendant Delaware corporation used a short-form merger to buy all of the minority stock of one of its subsidiaries. Rather than exercise their appraisal rights under the Delaware statute, the plaintiff minority shareholders brought a Rule 10b-5 action. The plaintiffs alleged that the parent corporation knowingly used a fraudulent appraisal as the basis of its offer, but plaintiffs failed to allege either misrepresentation or deception in the corporation's notice of purchase. The Court found that both the language and legislative history of section 10(b) mandated that misrepresentation or deception be proven in the cause of action. The plaintiffs failed in this proof and their recovery was denied. *Id.* at 477.

85. *Id.* (citing *Piper v. Chris-Craft Industries*, 430 U.S. 1, 41, *reh'g denied*, 430 U.S. 976 (1977)).



left Susan Norris to seek her remedy in the state courts for what was clearly a breach of her trustee's fiduciary duty. Instead, the Seventh Circuit held inconsistently with the Supreme Court trend, demonstrating an amenability to award a federal remedy.

Another interesting aspect of the *Norris* decision is the Seventh Circuit's expansion of the section 10(b) standing requirement. As noted by the *Norris* majority, the Supreme Court established the *Birnbaum* rule which limited the class of plaintiffs allowed standing under section 10(b) to those who actually purchase or sell a security.<sup>86</sup> The Courts of Appeals for the Second and Sixth Circuits have interpreted the rule to further allow standing to those directly impacted or benefited by the transaction.<sup>87</sup> Prior to *Norris v. Wirtz*, the Seventh Circuit had not ruled upon this expansion of the class of 10(b) plaintiffs. In *Norris*, the Seventh Circuit joined the Second and Sixth Circuits, finding that a trust beneficiary who feels the direct impact of a transaction has standing under section 10(b).

#### *Churning Under Rule 10b-5—Costello v. Oppenheimer & Co., Inc.*

In *Costello v. Oppenheimer & Co., Inc.*,<sup>88</sup> the Seventh Circuit addressed a customer's allegations of misrepresentation and churning by a brokerage firm in its handling of the customer's options and arbitrage trading accounts.

In September, 1976, the plaintiff Costello opened an options trading account with the defendant Oppenheimer, to be managed by Oppenheimer's employee Ronald Brownlow. Costello gave Brownlow instructions which specified Brownlow's allowable trading parameters, and emphasized that Costello wanted the principal of his new account absolutely protected. During two periods while Brownlow was absent from his office,<sup>89</sup> Brownlow's partner, Piet, executed transactions in Costello's account which violated Costello's trading parameters.<sup>90</sup> Costello complained on both occasions, and Brownlow twice assured him that the nonconforming trades would be remedied.

After having protested the handling of his account to Brownlow for

86. See *infra* note 74 and accompanying text.

87. See *infra* note 75 and accompanying text.

88. 711 F.2d 1361 (1983).

89. *Id.* at 1364-65. Brownlow was away from the office between March 25 and April 10, 1977, and again between June 25 and July 5, 1977.

90. *Id.* at 1365. Although Piet was Brownlow's partner, Brownlow had primary responsibility for Costello's account except on the two occasions when Brownlow was away. Brownlow terminated his partnership with Piet immediately upon Brownlow's return from his second vacation, on July 5, 1977.

several months,<sup>91</sup> Costello met with O'Donnell, an Oppenheimer Vice President and Branch Manager, in December 1977. O'Donnell acknowledged the mishandling of Costello's account, but convinced Costello to transfer his funds into an arbitrage account with promises that such an account would yield higher returns. Costello became dissatisfied as Oppenheimer turned his account over to a series of different account executives, and in September, 1978, he closed his account with Oppenheimer. Costello was shocked to learn that the value of his account had dropped from the \$275,906 market value quoted by Oppenheimer on December 31, 1977, to an actual market value of \$166,780 upon the account's closing.<sup>92</sup>

Costello commenced action for damages under section 10(b) of the 1934 Act, and Rule 10b-5.<sup>93</sup> His first count alleged that Oppenheimer made material misrepresentations of the market value of his arbitrage account.<sup>94</sup> Costello also alleged that Oppenheimer had "churned" his options account by engaging in excessive trading for the purpose of generating commissions.<sup>95</sup> The district court found that misrepresentations did occur in connection with the arbitrage account between January and April, 1978, and that the options account was churned between March and July, 1977. Costello was awarded damages reflecting only the decreases in the accounts' market values during the periods of misrepresentation and churning plus commissions charged during the churning period. Oppenheimer appealed, and the Seventh Circuit affirmed the finding of churning, reversed the finding of misrepresentation, and re-

91. *Id.* From July to November, 1977, there was little activity in Costello's account. Brownlow was trading defensively in an effort to reduce the losses that were occurring due to Piet's transactions. On November 19, 1977, Brownlow wrote a letter to O'Donnell, explaining why he had kept Costello's and other accounts relatively inactive. The reason, he explained, was that Piet had anticipated these accounts closing due to trading losses, so Piet "churned" the accounts to generate commissions. Brownlow voiced disagreement with Piet's practice, and on December 2, 1977 Brownlow's employment with Oppenheimer was terminated. *Id.* at 1365.

92. Costello had received the following market value quotations from Oppenheimer:

\$235,384.65 as of 9-7-76 (opening balance)

\$253,000.00 as of 7-22-77

\$234,196.65 as of 10-31-77

\$222,710.00 as of 11-18-77

\$275,906.25 as of 12-31-77

\$180,000.00 as of 7-12-78 (when Costello notified O'Donnell of his withdrawal)

\$160,780.95 as of 9-15-78 (closing balance)

*Id.* at 1372 n.20.

93. *Id.* at 1367. Section 10(b) and Rule 10b-5 are provided *supra* notes 66-67.

94. *Id.* at 1371. Specifically, Costello alleged that the \$275,906.25 value given to him by Oppenheimer in March, 1978, representing the December 31, 1977 market value, was misrepresented.

95. Costello alleged churning by Pite during the two periods Brownlow was away from his office, in March and July, 1977. See *supra* note 89-90 and accompanying text.

duced the award of damages to reflect only commissions paid during the period of churning.

The Seventh Circuit focused on the issue of churning. The court stated that the term "churning" in the context of securities regulation denotes a course of excessive trading through which a broker places his interest in generating commissions over the interests of his customer. Two elements must be proven in order to establish churning: 1) that the broker exercised control over the transactions in the account; and 2) that the amount of trading was excessive. Churning, if proven, is a per se violation of section 10(b) and Rule 10b-5.<sup>96</sup>

The *Costello* court had no trouble finding that Oppenheimer had control over the trades. Costello's account was discretionary, and Costello executed a power of attorney in favor of Oppenheimer granting Oppenheimer authority to make investment decisions without Costello's prior approval. Oppenheimer did in fact make such investment decisions, thereby exercising control over the transactions.<sup>97</sup>

The excessive trading element of churning requires that the volume of transactions be so excessive as to indicate that the broker intended to derive a profit for himself at the expense of his customer. The customer's investment objectives provide a standard against which to measure trading volume. The *Costello* court noted that Costello and Brownlow agreed on specific trading parameters within which all trades should have been executed. Furthermore, Costello repeatedly emphasized his objective to preserve the principal in the account. The *Costello* court found that Costello's investment objectives were "not unduly ambitious."<sup>98</sup>

Against Costello's investment objectives, the *Costello* court evaluated the volume of trades and amount of commissions. The court noted that Costello presented none of the traditional statistical or evidentiary measures of excessive activity. Among those traditionally used are the ratio of trades to commissions, "in and out" trading,<sup>99</sup> "cross trading",<sup>100</sup> "turnover rate",<sup>101</sup> timing and quality valuations, and expert testimony. Without the benefit of these tools, the *Costello* court looked to Piet's knowing violations of the trading parameters which Brownlow and

96. *Id.* at 1367-68.

97. *Id.* at 1368.

98. *Id.*

99. In and out trading refers to the partial or entire sale of the customer's portfolio, replacement with new securities, and sale of the newly acquired securities within a relatively short time period. *See id.* at 1369 n.9.

100. Cross trading is the broker's transferring of stock between customers. *See id.* n.10.

101. Turnover rate is the ratio of the total cost of purchases made for the account during a given period of time to the amount invested. *See id.* n.11.

Costello had agreed upon. The court also considered Brownlow's testimony of Piet's churning, and evidence that Oppenheimer executives admitted that the account was mishandled. The court held that these facts were sufficient to support a jury finding of excessive activity.<sup>102</sup>

The final issue discussed by the *Costello* court was damages. The court noted that two harms are suffered by victims of churning; realized losses due to unsuitable trades, and commissions charged for churned trades. Costello presented no evidence of realized losses, but instead attempted, and failed, to prove market value losses.<sup>103</sup> Therefore, the court could find no rational basis for awarding realized loss damages based on churning. The court awarded only losses based on commissions charged during the churning period.

In *Costello*, the Seventh Circuit made a significant departure from precedent by expanding the definition of the excessive trading element of churning. Churning has traditionally been characterized as a "unified offense": an offense not limited to any specific transaction or transactions. Rather, the essence of churning has been a broker's entire course of conduct and the aggregation of transactions.<sup>104</sup> In *Costello*, the Seventh Circuit held that nonconforming options trades constituted excessive activity. Under *Costello*, then, excessive activity can be established simply by a showing that specific trades violated the customer's trading parameters, without reference to the volume or pattern of activity.

In expanding the churning offense to include individual trading parameter violations, the Seventh Circuit left many questions unanswered. The traditional churning offense, a per se violation of section 10(b), requires that the volume of transactions be so excessive as to indicate a broker's placing his interest in generating commissions over the interest of his customer. The volume of transactions indicates fraud, irrespective

102. *Id.* at 1369-70. After finding that churning did occur, the Costello court examined at length, and rejected, Costello's allegations of misrepresentation. Because Costello presented no proof of the actual market value of his arbitrage account as of December 31, 1977, the court could not find that Oppenheimer's \$275,906 value was misrepresented. *Id.* at 1370-72. The court's lengthy analysis of market values was unnecessary to dispose of Costello's misrepresentation claim. See *O'Brien v. Continental Illinois National Bank*, 593 F.2d 54 (7th Cir. 1979) (where pension fund manager had full discretion to manage the stocks in the fund, the manager's misrepresentations to the fund trustees were not made "in connection with" the purchase or sale of securities).

103. 711 F.2d at 1374. Realized losses differ from market value losses in that a loss is not "realized" until a sale is made, because until sale a security can regain and exceed its original value thereby wiping out any loss. *Id.* This approach to awarding only realized loss damages has been criticized when applied to stock options, which have characteristics different from ordinary common stock. See generally Note, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571 (1984).

104. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th cir. 1970).

of whether the transactions conform to customer guidelines. However, the *Costello* court seemed to base its finding of churning not on the volume of trades, but rather on individual violations of customer-established trading parameters. It is unclear under *Costello* whether excessive trading is still an element of churning. If not, the offense is not really churning at all, but rather breach of contract. Such an offense would not likely be presumed fraudulent, as is churning, but would have to satisfy the literal requirements of section 10(b) in order to be actionable.

Another question unanswered in *Costello* is the applicability of the relaxed evidentiary standard. The *Costello* court recognized that its expansion of the definition of "excessive activity" to include parameter violations made some of the traditional evidentiary prerequisites to proof of churning unnecessary. No longer was there a need for statistical evidence or expert testimony, which has historically been used to show excessive trade volume or commissions. A factual showing that the customer's parameters were violated was sufficient. However, the court was silent as to whether the evidentiary standards should be relaxed in all churning cases, or only where the offense was based on nonconforming trades.

Finally, the recognition that churning can be established based upon individual trades has important implications for damages. The *Costello* court awarded commission damages for the entire period of churning, irrespective of individual transactions. Yet in discussing damages for realized losses, the court looked for identification of the specific wrongful trades and traces of their financial consequences.<sup>105</sup> This inconsistency highlights the confusion in the area of churning, and raises a question whether a plaintiff's claim of single parameter violations also places on the plaintiff the cumbersome burden of isolating every unsuitable transaction in order to recover damages.

#### BENEFICIAL OWNERSHIP UNDER SECTION 16(b)—*Colan v. Monumental Corp.*

Section 16(b) of the 1934 Act<sup>106</sup> was enacted for the purpose of preventing corporate insiders from deriving short-swing profits from the purchase or sale of their corporation's stock on the basis of information not available to others. Besides corporate officers and directors, the class

105. 711 F.2d at 1375 ("unlike the usual case in which churning is a unified offense established not on evidence of individual transactions but by proof that an overall course of trading has, in the aggregate, been excessive . . . it would have been possible [for *Costello*] to have identified the wrongful trades and to have traced their financial consequences.")

106. See *infra* note 110.

of insiders under 16(b) includes beneficial owners of more than 10% of a corporation's common stock. These insiders must disgorge profits made on their sale and purchase of any shares of the stock within any period of six months. In *Colan v. Monumental Corp.*,<sup>107</sup> the Seventh Circuit addressed the question of whether an owner of an option to buy stock is considered a beneficial owner under section 16(b), and thereby exposed to absolute liability for short-swing profits.

On November 14, 1978, defendant Kaufman and Broad, Inc. (K & B) owned 4.92% of Monumental Corporation's outstanding common stock. Two days later, K & B acquired an option to purchase another 5.15% of Monumental stock from Salomon Brothers, and a similar option to purchase 6.76% of Monumental's stock from Goldman Sachs & Co. K & B exercised the Salomon option on March 13, 1979, which brought its ownership of Monumental common stock to 10.06%. To evade any potential liability for short-swing profits that could arise under section 16(b), K & B sold 4000 shares of Monumental on April 24, 1979, decreasing K & B's ownership to 9.98%. On May 15, 1979, K & B entered into an agreement with Monumental under which Monumental could purchase all of K & B's holdings of Monumental stock, including the stock to be acquired through exercise of the Goldman option. The following day, K & B exercised the Goldman option.

David Colan, a Monumental shareholder, brought a derivative suit to recover short-swing profits allegedly made by K & B in violation of section 16(b). The district court granted K & B's motion for summary judgment, and Colan appealed. The Court of Appeals for the Seventh Circuit affirmed the district court's ruling.

On appeal, Colan argued that K & B's ownership of Monumental options made K & B a beneficial owner, for purposes of section 16(b), of the underlying Monumental stock. Colan relied on Rule 16a-2(b),<sup>108</sup> promulgated under section 16(a)<sup>109</sup> of the 1934 Act, which provides that

107. 713 F.2d 330 (1983).

108. Rule 16a-2b provides in pertinent part:

In determining for the purpose of section 16(a) of the Act whether a person is the beneficial owner . . . of more than ten percent of any class of equity securities, such person shall be deemed to be the beneficial owner of securities of such class which such person has a right to acquire through the exercise of presently exercisable options, warrants or rights.

17 C.F.R. § 240.16a-2(b) (1984).

109. Section 16(a) provides in pertinent part:

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . or who is a director or an officer of the issuer of such security, shall file . . . a statement with the [Securities and Exchange] Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner.

15 U.S.C. § 78p(a) (1982).

presently exercisable stock options are to be considered in the class of securities which compromise beneficial ownership under section 16(a). Section 16(b) is silent as to stock options, but refers to the definition of beneficial ownership in section 16(a) with the phrase "such beneficial owner."<sup>110</sup> Colan contended that because section 16(b) refers to section 16(a) in defining beneficial owner, the Rule 16a-2(b) beneficial owner definition is applicable to section 16(b).<sup>111</sup> This reasoning would make K & B a beneficial owner by virtue of its stock options, and K & B would be subject to liability during its period of beneficial ownership.

The court rejected Colan's argument, relying on a release by the Securities and Exchange Commission<sup>112</sup> which stated that beneficial ownership under 16(a) does not necessarily create liability under 16(b). The court reasoned that beneficial ownership under section 16(a) should be construed broadly, because section 16(a) merely places a filing requirement on beneficial owners. In contrast, section 16(b) places absolute liability on beneficial owners for short-swing profits, and should therefore be interpreted more narrowly. Given the difference in the scopes of sections 16(a) and 16(b), the *Colan* court refused to find liability under 16(b) for individuals falling within the broad ambit of section 16(a).<sup>113</sup>

110. Section 16(b) provides in pertinent part:

For the purpose of preventing the unfair use of information which may have been obtained by *such beneficial owner*, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner. . . . This subsection shall not be construed to cover any transaction where such owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved.

15 U.S.C. § 78p(b) (1982) (emphasis added).

111. 713 F.2d at 332-33. This argument has been raised in other cases. *See, e.g.*, *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir.) (viewing section 16(a) and section 16(b) as cohesive unit but rejecting presumption of equivalence), *cert. denied*, 454 U.S. 1081 (1981); *Whiting v. Dow Chem. Co.*, 523 F.2d 680 (2d Cir. 1975) (two sections should be read together to give effect to legislative intent); *Heli-Coil Corp. v. Webster*, 222 F. Supp. 831 (D.N.J. 1963) (section 16(b) must be read in conjunction with section 16(a) to determine whether director liable under section 16(b)), *aff'd*, 352 F.2d 156 (3d Cir. 1965); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965) (reporting provisions of section 16(a) only slightly significant in deciding section 16(b) liability).

112. The SEC release provided in pertinent part:

The fact that ownership of securities and transactions in those securities are reported under Section 16(a) of the Securities Exchange Act of 1934 does not necessarily mean that liability will result therefrom under Section 16(b). The question whether liabilities under Section 16(b) will arise from the transactions is, of course, to be determined by the facts of each particular case in an appropriate action brought by the issuer or its security holders.

Release No. 34-7824 (1960), 17 C.F.R. § 241.7824 (1983). This release was issued to clarify a portion of an earlier release, which stated that "[p]ersons required to file reports under Section 16(a) are also subject to Section 16(b) . . . of the Act." Release No. 34-7793 (1966), 17 C.F.R. § 241.7793 (1983).

113. 713 F.2d at 333 ("While it is true that the subsections are grammatically linked, and that

Having rejected Colan's Rule 16a-2(b) argument, the *Colan* court proceeded to a subjective test of whether stock options should be included in the 16(b) definition of beneficial ownership.<sup>114</sup> The court noted that the purpose of section 16(b) was to curb speculative abuse by those with access to inside information.<sup>115</sup> The *Colan* court reasoned that ownership of an unexercised option to acquire stock at some future time does not confer to the owner any of the benefits or rights of stock ownership. Therefore, option ownership provides no inside information, and no opportunity for abuse. The *Colan* court held that unexercised stock options, such as those held by K & B, were not to be included in the class of equity securities which determined beneficial ownership under section 16(b).<sup>116</sup>

Applying section 16(b) only to K & B's ownership of Monumental common stock, the *Colan* court found K & B not liable for short-swing profits. The court noted that K & B could only be liable under section 16(b) if it both purchased and sold Monumental stock within six months while it was a beneficial owner of more than 10% of the stock.<sup>117</sup> K & B became a beneficial owner on March 13, 1979, after it exercised the Salomon option. It subsequently sold 4000 Monumental shares. This sale was a 16(b) sale, but it brought K & B's ownership below 10%. K & B made no purchase while a beneficial owner to match with the sale. Accordingly, there was no liability under Section 16(b).

The Seventh Circuit's decision in *Colan* was in accord with Supreme Court precedent. Although the Supreme Court has never specifically ad-

there is a strong relationship between the definition of beneficial owner in 16(a) and the definition in 16(b), this does not mean that we must blindly apply 16(b) to every person who falls within the ambit of 16(a).").

114. Most courts apply such a subjective test. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th Cir. 1976); *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078, 424 U.S. 928 (1976); *Whiting v. Dow Chem. Co.*, 523 F.2d 680 (2d Cir. 1975); *Mouldings, Inc. v. Potter*, 465 F.2d 1101 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Petteys v. Butler*, 367 F.2d 528 (8th Cir.), *cert. denied*, 385 U.S. 1006 (1967); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *Altamil Corp. v. Pryor*, 405 F. Supp. 1222 (S.D. Ind. 1975); *Schur v. Salzman*, 365 F. Supp. 725 (S.D.N.Y. 1973); *American Standard, Inc. v. Crane Col.*, 346 F. Supp. 1153 (S.D.N.Y. 1971), *aff'd*, 510 F.2d 1043 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975).

115. 713 F.2d at 333 (citing *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972); *Portnoy v. Revlon*, 650 F.2d 895 (7th Cir. 1981); *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981)).

116. *Id.* at 333-34.

117. *Id.* at 334. Section 16(b) expressly provides for this. See *supra* note 110.



dressed the applicability of rules promulgated under section 16(a) to section 16(b), the Court has, on four occasions, interpreted section 16(b).<sup>118</sup> In each case, the Court ruled in favor of the insider. In the most recent of these cases, *Foremost-McKesson, Inc. v. Provident Securities Co.*,<sup>119</sup> the Court stated that “[i]t is inappropriate to reach the harsh result of imposing [section] 16(b)’s liability without fault on the basis of unclear language.”<sup>120</sup> The Court continued that if Congress wished to impose such liability, it must do so expressly or by unmistakable inference.<sup>121</sup> The Seventh Circuit correctly construed section 16(b) narrowly, holding that the broad disclosure requirements of section 16(a) should not impose absolute liability under section 16(b).

The *Colan* court also adhered to precedent in its application of a subjective test to determine whether stock options are securities for purposes of section 16(b) beneficial ownership. This subjective, or pragmatic, approach was adopted by the Supreme Court in *Kern County Land Co. v. Occidental Corp.*<sup>122</sup> The *Kern County* Court reasoned that all section 16(b) purchases and sales are not simply exchanges of cash for common stock, but many transactions, including those involving stock options, are unorthodox.<sup>123</sup> The Court held that in such a case, the proper inquiry is “whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information.”<sup>124</sup> The Seventh Circuit

118. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972); *Blau v. Lehman*, 368 U.S. 403 (1962); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976).

119. 423 U.S. 232 (1976). In *Foremost-McKesson*, Provident Securities sold convertible debentures to Foremost which were convertible into more than 10% of Provident’s outstanding common stock. Foremost sold a debenture which brought its holdings of Provident stock to less than 10% if converted, and Provident claimed under section 16(b) to recover Foremost’s short-swing profits. The Court examined the legislative history and intent behind section 16(b), noted that the 16(b) absolute liability provisions should be narrowly construed, and held that no liability should be imposed on Foremost unless it owned more than 10% of Provident *before* Foremost’s subsequent purchase and sale. The Court found Foremost not liable. *Id.* at 249-52.

120. *Id.* at 252.

121. *Id.*

122. 411 U.S. 582 (1973). In *Kern County*, Occidental Petroleum acquired more than 10% of Kern’s common stock through a tender offer. Kern defensively merged with Tenneco, and Kern’s shares were to be exchanged for Tenneco’s stock one-for-one. Less than one month after its initial tender offer, Occidental negotiated a binding option to sell its holdings to Tenneco at a date over six months after the tender offer expired. The sale took place, and Kern sought to recover Occidental’s profits under section 16(b). The Court ruled that although Occidental’s option agreement was binding and voluntarily entered into, its sale of *Kern County* stock was forced by the merger. Because of the involuntary nature of the sale, and the fact that Occidental’s *Kern County* holdings were not a source of potential insider abuse, Occidental was not liable under section 16(b) to disgorge profits. *Id.* at 600.

123. *Id.* at 593-94.

124. *Id.* at 594.

properly applied the *Kern County* subjective test in *Colan* to find that ownership of unexercised stock options presented no opportunity for insider abuse.

### DEFINITIONS OF INVESTMENT ADVISOR

An investment advisor, as provided in section 202(a)(11) of the Investment Advisors Act, is any person who, for compensation, engages in the business of advising others about the value of securities, or the advisability of transacting in securities, or who issues reports concerning securities for compensation and as part of a regular business.<sup>125</sup> In two decisions, the Seventh Circuit applied this definition. In *Securities and Exchange Commission v. Suter*,<sup>126</sup> the court upheld an injunction issued by the district court against the defendant Suter on the grounds that Suter was an investment advisor, and therefore subject to the anti-fraud proscriptions of section 206 of the Investment Advisors Act. In contrast, in *Wang v. Gordon*,<sup>127</sup> the provisions of the Investment Advisors Act were held inapplicable to a real estate partnership's general partner who was not found to be an investment advisor.

The defendant in *Suter* published an investment newsletter through his sole proprietorship, The National Publishing Company. The "National Portfolio Reporter" was Suter's newsletter which contained his strategy for investing in the stock market and his specific buy and sell recommendations. When Suter began including advice about commodities in the newsletter he changed its name to the "Profit Reporter." Subscribers to the newsletter were obtained through monthly mass mailings, which extolled Suter's investment success, his educational background, testimonials of satisfied customers, and guarantees of refunds to unsatisfied customers.

The S.E.C. brought an action to enjoin Suter from publishing the promotional mass mailings. At the preliminary injunction hearing, the district court found that Suter's advertisements made blatantly false representations, that Suter systematically cheated his subscribers and that

125. The definition of Investment Advisor is contained in section 202(a)(11) of the Investment Advisors Act, which provides in pertinent part:

"Investment advisor" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

15 U.S.C. § 80b-2(a)(11) (1982).

126. 732 F.2d 1294 (7th Cir. 1984).

127. 715 F.2d 1187 (7th Cir. 1983).

Suter made unregistered offerings of securities.<sup>128</sup> These activities were found to violate, among other regulations,<sup>129</sup> section 206 of the Investment Advisors Act.<sup>130</sup> Suter appealed the district court's finding of a section 206 violation, claiming that he was not an investment advisor as defined in section 202(a)(11)<sup>131</sup> and was therefore not subject to the prescriptions of the Investment Advisors Act. The Seventh Circuit upheld the district court's injunction.

Suter argued that he was not an investment advisor because section 202(a)(11)(D)<sup>132</sup> of the Investment Advisors Act excludes the publisher of any "bona fide newspaper" from the definition of investment advisor. The *Suter* court cited *Securities and Exchange Commission v. Wall Street Transcript Corp.*,<sup>133</sup> where the Second Circuit announced that the nature of the publication rather than the formal indicia of a newspaper should be examined in applying the bona fide newspaper exception.<sup>134</sup> This subjective approach was adopted and codified by the S.E.C., which stated that the bona fide newspaper exception should apply only where the publication is not primarily a vehicle for distributing investment advice.<sup>135</sup> In *Suter*, the court found that while Suter's publications had some of the purely formal indicia of a newspaper, their content consisted of investment advice about the stock market, particular buy and sell recommendations and reports on investments. Moreover, these newsletters were advertised as investment advice, Suter referred to himself as an investment advisor, and the readership was drawn from investors. The *Suter* court easily found that Suter's publications were primarily for investment advice, and therefore not subject to the bona fide newspaper exception to

128. 732 F.2d at 1297. The district court issued an injunction requiring Suter to maintain proper records, to make an accounting regarding funds received from the sale of securities, and to provide the SEC with copies of all of his future investment advisory publications. *Id.* at 1298.

129. The district court found that Suter violated the registration and anti-fraud provisions of the Securities Act of 1933; 15 U.S.C. §§ 77e, 77g (1976), and the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976). 732 F.2d at 1298.

130. For pertinent text of section 206, *see infra* note 138.

131. For pertinent text of section 202(a)(11), *see supra* note 125. Suter additionally claimed that his publication was protected by the First Amendment, that the district court erred in its findings of fact, conclusions of law, and the conditions of the Preliminary Injunction, and that the previous SEC administrative action to revoke Suter's investment advisor registration and the district court's receipt of evidence from the SEC proceeding violated Suter's constitutional rights. 732 F.2d at 1296.

132. The definition of investment advisor does not include "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation". 15 U.S.C. § 80-2(a)(11)(D) (1976).

133. 422 F.2d 1371 (2d Cir.), *cert. denied*, 398 U.S. 958 (1970).

134. "The determination of whether or not a given publication fits within this exclusion must depend upon the nature of its practices rather than upon the formal 'indicia of a newspaper' which it exhibits on its face and in the size and nature of its subscription list." 732 F.2d at 1298 (quoting *Wall Street Transcript Corp.*, 422 F.2d at 1377).

135. 732 F.2d at 1299 (quoting 17 C.F.R. § 276 (1977)).

the definition of investment advisor.<sup>136</sup> Accordingly, the Seventh Circuit affirmed the district court's injunction against Suter.

In the second case, *Wang v. Gordon*,<sup>137</sup> the plaintiff Wang was a limited partner in the Briarbrook Building Partners, a partnership formed in 1973 to own and operate a high-rise apartment building. The limited partnership agreement was amended in 1976 to name the defendant Gordon as general partner. The amended agreement further provided that Gordon would receive a brokerage commission on sales of partnership property. Gordon contracted with Inland Real Estate Corporation in 1981 for the sale of the apartment building and accordingly received a commission. Wang brought suit for damages under section 206 of the Investment Advisors Act alleging that Gordon defrauded the limited partners in arranging the sale.<sup>138</sup> Wang further alleged that under section 215 of the Act he was entitled to rescission of the partnership agreement and restitution of his pro rata share of the brokerage commission paid to Gordon.<sup>139</sup> The district court dismissed the action, holding that because Gordon was not an investment advisor under section 202(a)(11) of the 1934 Act,<sup>140</sup> there could be no liability under either section 206 or section 215. The Seventh Circuit affirmed the dismissal and adopted the district court opinion as its own.

The district court based its decision on the case of *Zinn v. Parrish*,<sup>141</sup> where the Seventh Circuit, interpreting the plain language of section 202(a)(11) of the Investment Advisors Act, held that an individual who does not "engage in the business" of giving investment advice is not an investment advisor. Wang alleged that Gordon issued investment advice to the limited partners through a letter which outlined the terms of the sale agreement and discussed the transfer of some securities. However, Wang made no allegation that Gordon issued investment advice as part of his regular business, as required by section 202(a)(11). Further, Gordon was not compensated for the information regarding securities in

136. *Id.* at 1299.

137. 715 F.2d 1187 (7th Cir. 1983).

138. Section 206 provides in pertinent part:

"It shall be unlawful for any investment advisor . . . to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

15 U.S.C. § 80b-6(4) (1982).

139. Section 215 provides in pertinent part:

Every contract made in violation of any provision of this subchapter 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 or this subchapter, or any rule, regulation, or order thereunder, shall be void.

15 U.S.C. § 80b-15(b) (1982).

140. *See supra* note 125.

141. 644 F.2d 360 (7th Cir. 1981).

the letter, but only received a brokerage commission for selling the building. Section 202(a)(11) limits the definition of investment advisor to those who are compensated for information on securities. Moreover, the district court noted that Gordon had exclusive authority to sell the building. The court reasoned that the information in the letter outlining the terms of the sale could not be considered "investment advice" because Wang had no input regarding the sale. Because Gordon neither engaged in the business of giving investment advice, received compensation for his advice, nor even gave investment advice, Gordon was not an investment advisor.<sup>142</sup>

### CONCLUSION

The Seventh Circuit decided eight securities cases during the 1983-84 term. The results of these decisions were mixed when compared to the law of the Supreme Court and other courts. In the area of implied private remedies, the court decided three cases; *Bassler v. Central National Bank in Chicago*, *Indiana National Corp. v. Rich*, and *Haas v. Wieboldt Stores, Inc.* In these decisions the court denied private rights of action under section 7(d), and announced private remedies under sections 13(d) and 14(a). The Seventh Circuit analyzed these cases in line with Supreme Court precedent, and decided in accord with the decisions of other circuits.

In contrast, the Seventh Circuit held against the trend in its section 10(b) anti-fraud decisions. In *Norris v. Wirtz*, the court displayed a distaste for self-dealing, and made a strained interpretation of a trust agreement to allow a plaintiff recovery. This decision contradicted recent Supreme Court decisions which limited recovery under section 10(b). In *Costello v. Oppenheimer*, the Seventh Circuit made its most significant departure from precedent by redefining broker churning. Other circuits had required statistical evidence or expert testimony in order to establish the excessive activity element of churning. However in *Costello*, the Seventh Circuit announced that such evidence is unnecessary. Excessive activity may now be established by a showing that a customer's trading parameters were violated. This decision may greatly broaden the number of plaintiffs who can recover for churning, and it also raises important questions about the need to isolate damages caused by each non-conforming trade.

142. The court refused to strain the investment advisor definition, noting that "the definitional requirements of the statute must be interpreted so as not to sweep in persons whose activities Congress did not intend to regulate on the theory that they posed no national concern." 715 F.2d at 1192-93 (quoting *Zinn v. Parrish*, 644 F.2d at 363).