

## SIPC--A First Impression (SEC v. Alan F. Hughes, Inc.)

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would not be available but for its initial bid. Second, the incentive to make tender offers for more than 10 percent of a company's stock would be seriously diminished since the maker of an unsuccessful take-over offer might be deprived of any gain by the unilateral maneuvers of a target corporation. Since tender offers are important means to effect an appreciation of stock or to replace inefficient management, their discouragement would be detrimental to stockholders of target corporations.

It would indeed be anomalous to deprive stockholders of potential benefit through a mechanistic application of section 16(b) which was designed to protect such stockholders. The Second Circuit, by recognizing the value of tender offers,<sup>81</sup> has avoided this anomaly.

#### SIPC — A FIRST IMPRESSION

##### *SEC v. Alan F. Hughes, Inc.*

Created by the Securities Investor Protection Act of 1970 (1970 Act),<sup>82</sup> the Securities Investor Protection Corporation (SIPC) is a non-profit membership corporation<sup>83</sup> whose fundamental objective is to provide financial protection for the customers of failing brokers and dealers (broker-dealers).<sup>84</sup> SIPC encountered its initial constitutional challenge in *SEC v. Alan F. Hughes, Inc.*<sup>85</sup> where the Second Circuit held that the statutory scheme under which customers of a broker-dealer are adjudicated to be in need of the protection of the 1970 Act is consistent with due process. The application of the statutory scheme, the court opined, was proper as evidenced by the record before it.<sup>86</sup>

All persons registered as broker-dealers under the Securities Exchange Act of 1934<sup>87</sup> and all persons, with certain specified exceptions,<sup>88</sup>

<sup>81</sup> The Second Circuit has previously provided protection for tender offerors. In *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (1969), the court held an investor liable under sections 9a(2) and 10(b) to a tender offeror whose offer was effectively negated by defendant's fraudulent manipulation of the price of the target company's stock.

<sup>82</sup> 15 U.S.C. §§ 78aaa *et seq.* (1970).

<sup>83</sup> 15 U.S.C. § 78ccc(a)(2). SIPC has all the powers, unless inconsistent with the 1970 Act, conferred upon a corporation under the District of Columbia Nonprofit Corporation Act. *Id.* § 78ccc(a)(3).

<sup>84</sup> 1 SIPC ANN. REP. 6 (1971). The term broker-dealer will be used to describe those brokers and dealers who are registered under section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78o) and those who are members of a national exchange. *See Gates, The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection*, 24 VAND. L. REV. 586 n.2 (1971).

<sup>85</sup> 461 F.2d 974 (2d Cir. 1972).

<sup>86</sup> *Id.* at 981.

<sup>87</sup> *See generally* 15 U.S.C. § 78o (1970).

<sup>88</sup> *See* 15 U.S.C. § 78ccc(a)(2)(B) (1970). Those excepted from the membership requirement include persons whose "business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts,

who are members of a national securities exchange are members of SIPC.<sup>89</sup> It is primarily from assessments<sup>90</sup> based upon the gross revenues<sup>91</sup> of these members that the SIPC fund is financed. There are, however, several other sources of monies available to SIPC.<sup>92</sup>

When SIPC is made aware<sup>93</sup> that a member firm is "in or is approaching financial difficulty,"<sup>94</sup> it must make a decision as to the financial stability of that firm.<sup>95</sup> If it is found that the broker-dealer has failed or is in danger of failing to meet its obligations to customers<sup>96</sup> and that at least one of five other conditions prevail,<sup>97</sup> SIPC may<sup>98</sup> file an

(ii) the sale of variable annuities, (iii) the business of insurance, or (iv) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts. . . ." *Id.*

<sup>89</sup> 15 U.S.C. § 78ccc(a)(2)(B) (1970). In addition, any person not eligible for membership within subsection (a) "may become a member of SIPC under such conditions and upon such terms as SIPC shall require." *Id.* § 78ccc(f)(1). As of December 31, 1971, it was reported that there were approximately 4,000 members of SIPC. 1 SIPC ANN. REP. 11 (1971). The largest SIPC membership affiliation, for purposes of the SIPC assessment, was with the National Association of Securities Dealers, Inc. *See* 1 SIPC ANN. REP. 11 (1971).

<sup>90</sup> *See generally* 15 U.S.C. § 78ddd(c) (1970). SIPC has been given the authority, by by-law or rule, to impose an assessment upon its members as it may deem "necessary and appropriate" to establish and maintain the SIPC fund. *Id.* § 78ddd(c)(2). This power, however, is not as extensive as it may first appear. The rate of general assessment may be in excess of one-half of one percent of gross revenues, a minimum assessment; but, in order for such an assessment to be made it must be determined that there will be no "material adverse effect on the financial condition of [the SIPC] members or their customers." In no event may there be an assessment in excess of one percent. *Id.* § 78ddd(c) and (d). *See* 1 SIPC ANN. REP. 14 (1971). Once the fund reaches a level of approximately \$150 million it is expected that assessments will vary as between classes of SIPC members. *Id.* at 16. *See* 15 U.S.C. § 78ddd(c)(2) (1970).

<sup>91</sup> The term "gross revenues" is defined in the 1970 Act at § 78ddd(i).

<sup>92</sup> Among these other sources of funds available to SIPC are: funds held by any trust which was established by a self-regulatory organization prior to January 1, 1970, 15 U.S.C. § 78ddd(e); borrowing from financial institutions pursuant to written agreement, *id.* § 78ddd(f); income on its investments; borrowing from the SEC, which can borrow from the Treasury, *id.* § 78ddd(g) and (h).

<sup>93</sup> *See* 15 U.S.C. § 78eee (1970). The SEC or any self regulatory organization must notify SIPC of any information which it possesses and which fosters a belief that a SIPC member is "in or is approaching financial difficulty." *Id.* § 78eee(a)(1).

<sup>94</sup> The term "financial difficulty" has *not* been defined. *See* 1 SIPC ANN. REP. 19 (1971).

<sup>95</sup> *See* 15 U.S.C. § 78eee(a)(2) (1970). It has been observed that a significant effect of the notice requirement of this section has been to cause the self-regulatory organization to more actively seek indications of financial weakness. 1 SIPC ANN. REP. 22 n.34 (1972).

<sup>96</sup> 15 U.S.C. § 78eee(a)(2) (1970). SIPC maintains that this is the most crucial question and the most difficult one for which facts must be collected. 1 SIPC ANN. REP. 22 (1971).

<sup>97</sup> The five conditions, at least one of which must be found, are that the SIPC member—

(i) is insolvent within the meaning of section 1(19) of Title 11, or is unable to meet its obligations as they mature, or

(ii) has committed an act of bankruptcy within the meaning of section 21 of Title 11, or

(iii) is the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such member has been appointed, or

(iv) is not in compliance with applicable requirements under the 1934 Act

application with the appropriate district court<sup>99</sup> for the appointment of a trustee.<sup>100</sup> Such an appointment will initiate liquidation proceedings in accordance with the 1970 Act,<sup>101</sup> and, if necessary, permit the advancement of SIPC funds to the trustee<sup>102</sup> as a means of satisfying certain customers' claims against the member firm.<sup>103</sup>

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or rules or regulations of the Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of customers' securities, or  
(v) is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules or regulations.

15 U.S.C. § 78eee(b)(1)(A) (1970).

<sup>98</sup> 15 U.S.C. § 78eee(a)(2) (1970). The filing of an application is discretionary with SIPC; however, if SIPC refuses to act the SEC has the authority to apply to a federal court for an order requiring SIPC to seek a decree adjudicating the customers of a member to be in need of the protection available under the 1970 Act. 15 U.S.C. § 78ggg(b). One basic explanation for the discretionary aspect of the application may be the fact that SIPC is authorized only to liquidate a firm. It may not reorganize a member in any manner. *See generally* 15 U.S.C. § 78fff (1970).

<sup>99</sup> 15 U.S.C. § 78eee(a)(2) (1970).

<sup>100</sup> *Id.* § 78eee(b)(3). While a trustee appointed pursuant to the 1970 Act has the same powers and title with respect to the debtor and the debtor's property, and the same rights to avoid preferences, as would be given a trustee under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 *et seq.* (1970), the SIPC trustee, in addition, may operate the debtor's business to complete "open contractual commitments." 15 U.S.C. § 78fff(b)(1) (1970). He may also hire those persons he deems necessary to facilitate the liquidation. *Id.* Both of these powers may be exercised without court approval. *Id.*

<sup>101</sup> 15 U.S.C. § 78eee(b)(3) (1970). The 1970 Act states that the liquidation proceeding is to be conducted:

in accordance with, and as though it were being conducted under, the provisions of Chapter X and such of the provisions (other than section 90(e) of Title 11) of Chapters I to VII, inclusive, of the Bankruptcy Act as section 502 of Title 11 would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with pursuant to the provisions of such Chapters I to VII

15 U.S.C. § 78fff(c)(1) (1970). It has been noted that the effect of this section is to integrate proceedings under the 1970 Act with straight bankruptcy and corporate reorganizations procedures under the Bankruptcy Act. 1 SIPC ANN. REP. 24 (1971). The result is less than desirable due to the inconsistencies of these various proceedings and their fundamental objectives. *See id.* at 24 n.38.

<sup>102</sup> *See* 15 U.S.C. § 78fff(f) (1970).

In order to provide for prompt payment and satisfaction of the net equities of customers of debtor, SIPC shall advance to the trustee such moneys as may be required to pay or otherwise satisfy claims in full of each customer, but not to exceed \$50,000 for such customer. . . .

*Id.* If the advance is for the purpose of covering a customer's claim for a cash loss, it may not exceed \$20,000. *Id.*

SIPC is entitled to be subrogated to the claims of certain customers for whom advances are made to the trustee. *Id.* § 78fff(f)(1) (1970). This provision, however, need not be exercised in order for SIPC to recover advances made to the trustee for the completion of "open contractual commitments." SIPC is entitled to priority to all claims payable from the "single and separate fund" for this amount. *Id.* § 78fff(d). *See generally* note 103 *infra*.

<sup>103</sup> In abrogating section 60(e) of the Bankruptcy Act, the 1970 Act has created three classes of claimants to a SIPC member's assets. *See* 15 U.S.C. § 78fff (1970); 1 SIPC ANN. REP. 25 (1971). Generally, these are: (1) those who can "specifically identify" their property in the hands of the debtor, (2) those entitled to share pro rata in a "single and separate fund," and (3) those not in either of the two preceding categories who share in the remaining assets of the debtor with other creditors. *Id.*

The contention in *SEC v. Alan F. Hughes, Inc.*<sup>104</sup> was that the district court's appointment of the trustee under the 1970 Act had denied appellants, Alan F. Hughes, Inc. and Alan F. Hughes,<sup>105</sup> due process because SIPC had not given them notice and a hearing as to the determination that there was a danger that Alan F. Hughes, Inc. would fail to meet its obligations to its customers within the meaning of the 1970 Act.<sup>106</sup> Essential to this assertion was the argument that section 5(b)(1)<sup>107</sup> of the 1970 Act precludes a district court from making its own finding as to whether a SIPC member is in danger of failing to meet its obligations to its customers.<sup>108</sup>

Appellants' argument was rejected by the court upon the theory that "SIPC's determination is merely a preliminary step" and, "in and of itself, has no binding legal consequences and deprives no broker-

<sup>104</sup> 461 F.2d 974 (2d Cir. 1972). The SEC is a party to the action because an equity receiver was appointed for Alan F. Hughes, Inc. prior to appointment of the SIPC trustee. In its annual report SIPC remarked that in most cases in which it had filed applications, its action has been subsequent to or concurrent with the SEC's application for an injunction and appointment of a receiver. This rationale springs from a reluctance by SIPC to invoke liquidation proceedings unless they are absolutely necessary. *See* 1 SIPC ANN. REP. 8 (1971).

Appellants, in this case, in addition to a claim of denial of due process, also challenged this aspect of the procedure, *i.e.*, they contested the appointment of a receiver. The Second Circuit held that the SEC had presented sufficient evidence to the district court to support its application for the appointment of a receiver. 461 F.2d at 983. Further, the court noted that the district court had made such an appointment in order to conserve the assets of the appellant while SIPC was making its determination. *Id.*

The appointment of a receiver is not a power which is expressly granted in the Securities Exchange Act of 1934. 3 LOSS, SECURITIES REGULATION 1510 (2d ed. 1961). Rather, the power is regarded as a form of ancillary relief available through a general grant of equitable jurisdiction, 15 U.S.C. § 78aa (1970), and the regulatory goals of the SEC. *See* Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). The issue was directly decided in the affirmative in *SEC v. H. S. Simmons & Co.*, 190 F. Supp. 432 (S.D.N.Y. 1961), and it is now well accepted that the federal courts may appoint an equitable receiver upon the application of the SEC. *See, e.g.*, *SEC v. Charles Plohn & Co.*, 433 F.2d 376, 379 (2d Cir. 1970); *Lankenau v. Coggeshall & Hicks*, 350 F.2d 61, 63 (2d Cir. 1965).

An important distinction to be maintained between an equity receiver and a SIPC trustee is that the receiver is to preserve the assets of the debtor and liquidate them only if the exigencies of the moment mandate such, whereas a SIPC trustee can *only* liquidate the assets of the debtor. *See* *SEC v. Bartlett*, 422 F.2d 475, 477 (8th Cir. 1970); *Lankenau v. Coggeshall & Hicks*, 350 F.2d 61 (2d Cir. 1965); *Esbitt v. Dutch-American Mercantile Corp.*, 335 F.2d 141, 143 (2d Cir. 1964); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960); 15 U.S.C. § 78fff(c)(1) (1970).

<sup>105</sup> Alan F. Hughes was the principal stockholder, a director, and president of Alan F. Hughes, Inc. The latter was a member of SIPC by virtue of its being a registered broker-dealer within the 1970 Act. 461 F.2d at 977.

<sup>106</sup> *See* note 97 *supra*.

<sup>107</sup> 15 U.S.C. § 78ccc(b)(1) (1970).

<sup>108</sup> *See* note 110 *infra*. It was agreed by the parties that the trustee could proceed during the pendency of the appeal with his duties under the 1970 Act. He could not, however, proceed with the actual liquidation of the member firm. 461 F.2d at 979.

dealer of property."<sup>109</sup> It was conceded that a literal reading of section 5(b)(1)(A)<sup>110</sup> would place the constitutionality of the 1970 Act in question,<sup>111</sup> since a SIPC application could be granted even though there was no showing that the broker-dealer was in danger of failing to meet its obligations to its customers.<sup>112</sup> Basic rules of statutory construction, however, were cited by the court in its finding that the statutory scheme was consistent with due process.<sup>113</sup> The court concluded that due process mandates that the district court make its determination as a result of a de novo proceeding "rather than from some lesser process merely involving judicial review of the initial administrative determination."<sup>114</sup>

With regard to the issue of a de novo hearing, the court held that the record in this case did not support an allegation by the appellants that the appointment of the trustee had violated their right to due process.<sup>115</sup> It was remarked that "the [district] court did not rely solely

<sup>109</sup> *Id.*

<sup>110</sup> 15 U.S.C. § 78eee(b)(1)(A) (1970).

A court to which application is made pursuant to subsection (a)(2) of this section shall grant the application and issue a decree adjudicating that customers of the member named in the application are in need of protection under this chapter if it finds that such member [is within one of the five conditions listed as a prerequisite to SIPC's filing of an application with the district court] . . . .

*Id.* (emphasis added). See notes 96 & 97 *supra*.

<sup>111</sup> 461 F.2d at 980.

<sup>112</sup> *Id.*

<sup>113</sup> 461 F.2d at 980, citing *Crowell v. Benson*, 285 U.S. 22, 62 (1932). The court regarded the question as being one of interpreting legislative intent, and presumed that the Congress would not seek unconstitutionality. 461 F.2d at 980.

<sup>114</sup> 461 F.2d at 979. Due process, in essence, mandates an "opportunity to be heard." *Milliken v. Meyer*, 311 U.S. 457, 463 (1940). When this opportunity must be granted depends on the nature of the rights being asserted; nevertheless, the hearing must be "at a meaningful time and in a meaningful manner." *Armstrong v. Manzo*, 380 U.S. 545, 552 (1965).

For example, in *Goldberg v. Kelly*, 397 U.S. 254 (1970), a hearing subsequent to the termination of subsistence benefits could deprive the eligible recipient of his means of survival, and, thereby, affect his means or ability to properly contest the termination. In its recognition that the state's interest in preserving funds did not override the individual interest, the court, in *Goldberg*, implicitly accepted a theory that private interests could be overridden under proper circumstances. 397 U.S. at 266. A balance, therefore, is to be struck between the private and public interests involved in a particular case when one considers the timing of a hearing. See *R. A. Holman & Co. v. SEC*, 299 F.2d 127, 132 (D.C. Cir.), cert. denied, 370 U.S. 911 (1962); *Fahey v. Mallonee*, 332 U.S. 245, 253 (1947).

There is provision in the 1970 Act by which a member firm can consent to the SIPC application to a district court. In the event of a consent, it does not appear that a hearing is required. See 15 U.S.C. § 78eee(f)(1)(B); 1 SIPC ANN. REP. 23 (1971).

<sup>115</sup> 461 F.2d at 981. Due process establishes certain minimum requirements for the scope of a hearing, regardless of its timing. The hearing must be "appropriate to the nature of the case." *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950). Professor Davis indicates that the nature of the hearing may be influenced by the

upon oral statements made during the hearing. . . . Rather, the court relied upon all the evidence which had been accumulating from the time the . . . [action was] initially commenced."<sup>116</sup> SIPC, in fact, had conceded at the district court proceeding that the court should make its own finding about the ability of Hughes, Inc. to meet its obligations to customers within the meaning of the 1970 Act.<sup>117</sup> On the facts of the case, the Second Circuit found that the district court had recognized its responsibility under the 1970 Act, and that its responsibility had been fulfilled upon sufficient evidence.<sup>118</sup>

The importance of the decision rendered by the Second Circuit in this case stems not from the complexity of the issues involved, but rather from the fact that it is a case of first impression.<sup>119</sup> In *SEC v. Alan F. Hughes, Inc.* the court made the initial adjudication of constitutional considerations under the 1970 Act.<sup>120</sup>

#### ARBITRATION

*Axelrod & Co. v. Kordich, Victor & Neufeld*  
*Coenen v. Pressprich*

An apparent conflict between stock exchange rules and provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 was resolved when the Second Circuit, in separate cases, held 1) that a non-member may use the rules of an exchange to compel a member firm to arbitrate a dispute and 2) that a member firm may likewise compel an allied member to arbitrate.

In the first case, *Axelrod & Co. v. Kordich, Victor & Neufeld*,<sup>121</sup> the non-member defendant, alleging breach of a common stock purchase contract,<sup>122</sup> had commenced arbitration proceedings before the

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question to be resolved. If a case places "adjudicative facts" in dispute, a trial seems best suited. 1 DAVIS, ADMINISTRATIVE LAW TREATISE § 702, at 413 (1958).

The complex fact questions raised in a determination as to the financial stability of a SIPC member are of an adjudicative nature and, therefore, worthy of a due process hearing. No such hearing was guaranteed upon the initial determination and, as the Second Circuit concluded, a cursory review of the initial findings would not remedy the due process issue. See generally 461 F.2d at 979 n.8.

<sup>116</sup> 461 F.2d at 981.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 982.

<sup>119</sup> *Id.* at 976.

<sup>120</sup> Prior to the instant case the only other aspect of the 1970 Act which had been adjudicated was the question of retroactivity. It was held in *Loff v. Casey*, 330 F. Supp. 356 (D. Colo. 1971) (mem.), *aff'd*, CCH FED. SEC. L. REP. ¶ 93,589 (10th Cir.), that the 1970 Act affords protection only to the customers of those firms which were actually in business on or after the effective date of the legislation. In the *Loff* case the firm seeking 1970 Act status had been adjudicated a bankrupt prior to December 30, 1970. *Id.* at 357.

<sup>121</sup> 451 F.2d 838 (2d Cir. 1971).

<sup>122</sup> *Axelrod* had contracted to purchase five thousand shares of On Site Energy Sys-