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CONVERSION OF CUSTOMERS' PROPERTY BY SECURITIES PROFESSIONALS: THE APPLICABILITY OF RULE 10b-5 IN THE "CONTRACTION ERA"

The provisions of section 10(b) of the Securities Exchange Act of 1934 (section 10(b))¹ and Rule 10b-5² provide the investing public with redress for a wide variety of grievances related to securities transactions.³AA Securities brokers conduct innumerable securities transactions, and, therefore, securities brokers are often the subject of Rule 10b-5 claims in connection with broker management of customer investment accounts.⁴ Rule 10b-5 provides significant protection to brokerage customers.⁵

Broker customers occasionally seek Rule 10b-5 protection from broker conversions of the customer property. The tort of conversion occurs when a person exercises dominion and control over property in a manner incon-

1. 15 U.S.C. § 78j(b) (1976). Section 10(b) of the Securities Exchange Act of 1934 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-. . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

2. 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5, which the Securities Exchange Commission promulgated under section 10(b) of the Securities Exchange Act of 1934, provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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 as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

3. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979). Rule 10b-5 applies to the trading of securities on the basis of undisclosed material information, the distribution of misleading information about a corporation, selective disclosures of material nonpublic information, which is known as tipping, manipulation of a securities market, improper management of a corporation, and improper actions by securities brokers. *Id.*; see Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 On Broker-Dealers*, 57 CORNELL L. REV. 869, 870-71 (1972) (discussing applicability of Rule 10b-5 to broker-dealer activities).

4. See A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 210 (1986) (discussing use of Rule 10b-5 as cause of action against securities brokers for mismanagement of customer accounts); Jacobs, *supra* note 3, at 876-973 (same); Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1279-91 (1983) (same).

5. See JACOBS, *supra* note 4, at § 210 (discussing Rule 10b-5 provision of redress to customers against securities brokers for mismanagement of customers accounts); Jacobs, *supra* note 3, at 876-973 (same); Langevoort, *supra* note 4, at 1279-91 (same).

sistent with the rights of the property owner.⁶ Brokers can convert customer property in a number of ways.⁷ The broker may steal cash or securities from the customer's account,⁸ or pledge customer securities to a third party lender as collateral for loans to the broker or to the brokerage firm.⁹ The broker also may convert customer property by engaging in unauthorized trading, which involves purchasing or selling securities on behalf of the customer without the customer's consent.¹⁰ Prior to the "Contraction Era"¹¹, during which the United States Supreme Court has restricted the scope of Rule 10b-5, broker conversions of customer property were valid bases for Rule 10b-5 claims.¹² Since the advent of the Contraction Era, however, the federal courts have struggled to determine the applicability of Rule 10b-5 to acts of conversion by securities brokers.¹³ Inconsistency among federal court decisions concerning the applicability of Rule 10b-5 to broker con-

6. W. PROSSER & P. KEETON, *LAW OF TORTS*, 90 (5th ed. 1984).

7. See *infra* notes 8-10 and accompanying text (discussing ways by which broker can convert customer property).

8. See PROSSER, *supra* note 6, at 96 (theft of property constitutes conversion).

9. See *id.* (non-owner's pledge of property without authority from owner is conversion).

10. See *id.* (unauthorized use of property by individual other than property owner is conversion).

11. See 2 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 2.2, at (460)-(63) (1986) [hereinafter BROMBERG] (coining term "Contraction Era"). The Contraction Era refers to the present period in the history of Rule 10b-5. *Id.* The Contraction Era began in 1975 with the United States Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, restricting standing in Rule 10b-5 actions. *Id.* § 2.2, at (460)-(63); see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *infra* notes 15-31 and accompanying text (discussing *Blue Chip Stamps*). Since 1975 the Supreme Court consistently has ruled against expanding the scope of Rule 10b-5. BROMBERG, *supra*, §2.2, at (460)-(63).

12. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-11 & 11 n.7 (1971) (misappropriation of proceeds of sale of security violates Rule 10b-5); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1094-95 (2d Cir. 1972) (misappropriation of securities violates Rule 10b-5); *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971) (Rule 10b-5 applies to scheme to convert stock); *SEC v. Charles Plohn & Co.*, 433 F.2d 376, 377 (2d Cir. 1970) (broker's unauthorized pledge of customer securities violates Rule 10b-5); *Newman v. Smith*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P95,078, at 97,785 (S.D.N.Y. 1975) (broker's unauthorized trading of customer securities violates Rule 10b-5); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 442-43 (N.D. Cal. 1968) (broker theft of customer securities, facilitated by ruse on customer, violates Rule 10b-5), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 444 (N.D. Ill. 1967) (broker misappropriation of cash, which customer had remitted to broker to pay for securities that customer had ordered, violates Rule 10b-5); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (broker conversion of customer cash violates Rule 10b-5). See generally JACOBS, *supra* note 4, §§ 38.02[b], at nn.48-50; 67.02; 212.04; 213 (discussing Rule 10b-5 applicability to broker conversions of customer property); JACOBS, *supra* note 3, at 955, 957-58 (same); Langevoort, *supra* note 4, at 1287 n.172 (same).

13. See JACOBS, *supra* note 4, at § 213 (discussing applicability of Rule 10b-5 to broker conversions of customer property); *infra* notes 42-140 and accompanying text (discussing judicial precedent concerning applicability of Rule 10b-5 to broker conversion of customer property).

versions has created significant confusion in an important area of securities law.¹⁴

The decisions of the United States Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*¹⁵ and *Santa Fe Industries, Inc. v. Green*¹⁶ marked the advent of the Contraction Era and provide limiting principles that restrict the scope of causes of action under Rule 10b-5.¹⁷ In *Blue Chip Stamps*, the plaintiff, an investor, claimed that the prospectus of an issuing corporation purposely and fraudulently had understated the company's value.¹⁸ The plaintiff further claimed that in reliance upon the information in the prospectus, the plaintiff had refrained from purchasing securities and had suffered damage as a result.¹⁹ The United States District Court for the Central District of California dismissed the plaintiff's complaint for failure to state a claim under Rule 10b-5.²⁰ The district court held that a Rule 10b-5 plaintiff must be a purchaser or seller of securities and that permitting nonpurchasers and nonsellers to have Rule 10b-5 standing improperly would allow recovery for speculative and conjectural losses.²¹ In reversing the district court's decision, the United States Court of Appeals for the Ninth Circuit found that some plaintiffs who were not purchasers or sellers nonetheless could prove satisfactorily that the defendant's wrongdoing prevented the plaintiff from transacting in securities.²² The Ninth Circuit opined that a nonpurchaser or nonseller should have the opportunity to prove a Rule 10b-5 claim, and that dismissal for failure to state a claim merely because a plaintiff actually had not transacted in securities was too strict a limitation upon the scope of Rule 10b-5.²³ The Supreme Court, however, agreed with the district court and held that the plaintiff did not have standing to bring a claim under Rule 10b-5 because the plaintiff had not purchased or sold any security.²⁴

14. See *infra* notes 42-140 and accompanying text (discussing conflicting federal court decisions concerning applicability of Rule 10b-5 to broker conversion of customer property).

15. 421 U.S. 723 (1975).

16. 430 U.S. 462 (1977).

17. See BROMBERG, *supra* note 10, § 2.2, at (460)-(63) (discussing *Blue Chip Stamps v. Manor Drug Stores* and *Santa Fe Industries, Inc. v. Green* as among landmark cases restricting scope of Rule 10b-5). Federal courts commonly define the elements of a Rule 10b-5 cause of action as the use of a facility or means of interstate commerce to facilitate fraud, manipulation, or deception in connection with the purchase or sale of securities, with reckless disregard for the interests of the plaintiff, and causing damage to the plaintiff. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979). See generally JACOBS, *supra* note 4, at § 36 (discussing elements of Rule 10b-5 cause of action).

18. *Blue Chip Stamps*, 421 U.S. at 726-27.

19. *Id.*

20. *Blue Chip Stamps v. Manor Drug Stores*, 339 F.Supp. 35, 40 (C.D. Cal. 1971).

21. *Id.* at 40.

22. *Blue Chip Stamps v. Manor Drug Stores*, 492 F.2d 136, 141-42 (9th Cir. 1973).

23. *Id.* at 142.

24. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975).

The Supreme Court in *Blue Chip Stamps* discussed several practical grounds for the decision to deny the plaintiff's standing.²⁵ The Court noted that because the plaintiff actually had not transacted in securities, any award of damages would be speculative and conjectural.²⁶ The Court also opined that a decision to grant the plaintiff standing would spawn limitless and vexatious litigation.²⁷ Furthermore, the Supreme Court determined that questions of credibility and questions of fact that were not objectively verifiable would permeate litigation because the weight of the plaintiff's case would rest upon his oral testimony regarding his intention to purchase securities.²⁸ The Court noted that if the plaintiff was not a purchaser or seller, the plaintiff's Rule 10b-5 claim would be difficult to dispose of prior to trial, and would place undue pressure on the defendant to settle a potentially baseless claim.²⁹ The Supreme Court also noted that recognizing standing under Rule 10b-5 for persons who had neither purchased nor sold securities would force the defendant corporation to conduct business under the pressure and risk of limitless liability to a limitless class.³⁰ The Supreme Court found that the practical ramifications of recognizing standing for nonpurchasers and nonsellers demanded that standing under Rule 10b-5 extend only to persons who had transacted in securities, and not to persons who claimed that they would have transacted in securities absent the defendant's wrongdoing.³¹

The Supreme Court provided the second relevant limitation on the scope of Rule 10b-5 in *Santa Fe Industries, Inc. v. Green*.³² In *Santa Fe* minority shareholders alleged that the majority shareholders had breached fiduciary duties owed to the minority shareholders when the majority approved a short form merger.³³ The dissenting minority shareholders retained only the appraisal rights to their stock as a result of the short form merger.³⁴ The United States District Court for the Southern District of New York dismissed the minority shareholders' complaint for failure to state a Rule 10b-5 claim

25. *Id.* at 734-55; see *infra* text accompanying notes 26-31 (discussing practical concerns that Supreme Court expressed in *Blue Chip Stamps v. Manor Drug Stores*).

26. *Blue Chip Stamps*, 421 U.S. at 734-35.

27. *Id.* at 739.

28. *Id.* at 742 and 746.

29. *Id.* at 742.

30. *Id.* at 748.

31. *Id.* at 755.

32. 430 U.S. 462 (1977).

33. *Id.* at 467. A short form merger is a merger of a subsidiary corporation into a parent corporation that occurs with the voting approval of neither parent nor subsidiary corporation shareholders. HAMILTON, CORPORATION FINANCE 509 (1984). Short form merger procedures are typically only available when the parent corporation owns 90% or more of the subsidiary's stock. *Id.* Parent corporations often use short form mergers to divest minority stockholders in the subsidiary of the minority stockholders' stock ownership interests. *Id.* As a result of a short form merger dissenting minority stockholders in the subsidiary retain only rights to appraisal and cash payment for the value of their stock. *Id.*

34. *Santa Fe*, 430 U.S. at 466.

because the plaintiffs had not alleged that the defendant shareholders had engaged in any manipulative or deceptive activity in connection with the short form merger.³⁵ The United States Court of Appeals for the Second Circuit, in reversing the district court's decision, found that the minority shareholder's stated a valid Rule 10b-5 claim.³⁶ The Second Circuit held that a breach of fiduciary duty in connection with the approval of a short form merger was within the scope of Rule 10b-5 and that a Rule 10b-5 plaintiff need not allege that the defendant made material misrepresentations or nondisclosures.³⁷

The Supreme Court, in reversing the decision of the Second Circuit, found that the gravamen of the plaintiffs' complaint was that the majority shareholders had breached a duty to the minority shareholders to treat the minority fairly.³⁸ The Court held that a breach of fiduciary duty in connection with the purchase or sale of securities, absent any deception, misrepresentation, or nondisclosure, does not violate Rule 10b-5.³⁹ The Supreme Court noted that causes of action for breaches of fiduciary duties were traditionally the subject of state corporate law, and that providing a cause of action under Rule 10b-5 unduly might supplant state law.⁴⁰ The Court determined that the language of Rule 10b-5 should guide the Court's interpretation of Rule 10b-5 in considering the case and that, because Congress had not provided expressly for the application of Rule 10b-5 to conduct solely involving breaches of fiduciary duty, the extension of Rule 10b-5 to cases exclusively concerning breaches of fiduciary duty was unmerited.⁴¹

The Supreme Court decisions in *Blue Chip Stamps* and *Santa Fe* have forced the federal courts to reconsider whether broker conversions of customer property constitute acts of fraud, manipulation, or deception in connection with the purchase or sale of securities to which Rule 10b-5 should apply.⁴² The federal courts have adopted three basic positions in resolving questions of Rule 10b-5 applicability to broker conversions of

35. *Santa Fe Indus., Inc. v. Green*, 391 F. Supp. 849, 854 (S.D.N.Y. 1975).

36. *Santa Fe Indus., Inc. v. Green*, 533 F.2d 1283, 1289 (2d Cir. 1976).

37. *Id.* at 1287.

38. *Santa Fe*, 430 U.S. at 477.

39. *Id.* at 476.

40. *Id.* at 478-79.

41. *Id.* at 477.

42. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (holding that fraud, manipulation, or deception by defendant must exist for plaintiff to state claim under Rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 726-27 (1975) (holding that plaintiff must be purchaser or seller of securities to achieve standing under Rule 10b-5). The *Blue Chip Stamps* and *Santa Fe* decisions have forced the federal courts to reconsider the applicability of Rule 10b-5 to broker conversions of customer property because the purchase-or-sale and fraud, manipulation, or deception requirements are not readily adaptable to situations involving broker conversions of customer property. See *infra* notes 157-80 and accompanying text (discussing how purchase-or-sale and fraud, manipulation, or deception requirements apply to situations involving broker conversions of customer property).

customer property. The permissive view allows customers to assert Rule 10b-5 claims for any acts of conversion by brokers.⁴³ The strict view asserts that customer claims based on broker conversion of the customer property never are proper claims under Rule 10b-5.⁴⁴ The third view attempts to distinguish among various acts of conversion, with the result that some broker conversions of customer property fall within the scope of Rule 10b-5 while other conversions do not fall within the scope of Rule 10b-5.⁴⁵

In espousing the permissive view, the United States Court of Appeals for the Sixth Circuit has chosen the most liberal of the three views regarding the applicability of Rule 10b-5 to broker conversions of customer property.⁴⁶ In *Mansbach v. Prescott, Ball & Turben*,⁴⁷ a broker induced a customer to engage the broker for the purpose of transacting in the options market.⁴⁸ The customer pledged corporate bonds to the broker as collateral for the options transactions.⁴⁹ The customer retained authority over all trading activity in his account.⁵⁰ The relationship between the broker and the customer deteriorated when the broker allegedly failed to execute transactions according to the customer's orders and made securities purchases that the customer did not authorize.⁵¹ Furthermore, when the customer decided to terminate the customer's account with the broker, the broker allegedly refused to return the customer's bonds unless the customer signed a release absolving the brokerage firm from all liability.⁵² The customer brought suit in the United States District Court for the Western District of Kentucky, claiming that the broker had violated Rule 10b-5 by trading in excess of the broker's delegated authority and by holding the customer's pledged bonds contrary to the customer's order.⁵³ The district court dismissed the plaintiff's complaint for failure to state a claim under Rule 10b-5.⁵⁴

43. See *infra* notes 46-62 and accompanying text (discussing permissive view of Rule 10b-5 applicability to broker conversions of customer property).

44. See *infra* notes 63-95 and accompanying text (discussing strict view regarding applicability of Rule 10b-5 to broker conversions of customer property).

45. See *infra* notes 96-138 and accompanying text (discussing view that attempts to distinguish between various broker conversions in determining applicability of Rule 10b-5 to broker conversions of customer property).

46. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) (adopting permissive application of Rule 10b-5 to broker conversions of customer property).

47. 598 F.2d 1017 (6th Cir. 1979).

48. *Id.* at 1019.

49. *Id.*

50. *Id.* The customer plaintiff in *Mansbach v. Prescott, Ball & Turben* maintained a nondiscretionary account with the defendant broker. *Id.* When the customer maintains a nondiscretionary account, the customer does not delegate authority to the broker to trade securities on the customer's behalf unless the customer gives the broker prior authorization. See JACOBS, *supra* note 4, at § 212.01 n.6 (discretionary account involves delegation of authority to broker to trade securities on behalf of customer).

51. *Mansbach*, 598 F.2d at 1020.

52. *Id.* at 1020-21.

53. *Id.* at 1026-27.

54. *Id.* at 1022. In *Mansbach*, the district court found that the plaintiff's claim that

In reversing the decision of the district court, the Sixth Circuit found that the customer's claims that the broker had engaged in unauthorized trading and that the broker had converted the customer's bonds were both within the scope of Rule 10b-5.⁵⁵ The *Mansbach* court declared that brokers are fiduciaries who owe a high degree of care to customers in managing customer accounts.⁵⁶ The Sixth Circuit found that reckless trading in a customer's account, contrary to the customer's wishes, is a manipulative and deceptive practice in connection with the purchase or sale of securities.⁵⁷ The Sixth Circuit thus held that Rule 10b-5 applied to reckless unauthorized trading in a customer's account.⁵⁸ Furthermore, the *Mansbach* court noted

the broker had violated Rule 10b-5 by engaging in unauthorized trading was not within the scope of Rule 10b-5 because the broker had acted only negligently and Rule 10b-5 did not apply to negligent conduct. *Id.* See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976) (Rule 10b-5 does not apply to negligent conduct). The district court also found that the plaintiff's allegation that the broker had converted the plaintiff's bonds failed to state a claim under Rule 10b-5 because the conversion was not in connection with the purchase or sale of a security. *Mansbach*, 598 F.2d at 1022. The district court's opinion is not officially reported. *Id.* at 1019.

55. *Mansbach*, 598 F.2d at 1026-27.

56. *Id.* at 1026 (brokers are fiduciaries who owe high duty of care to customers in managing customer accounts); see *Dirks v. SEC*, 681 F.2d 824, 840 (D.C. Cir. 1982) (Rule 10b-5 imposes higher standards upon brokers than upon other persons who engage in securities transactions), *rev'd on other grounds*, 463 U.S. 646 (1983); *O'Neill v. Maytag*, 339 F.2d 764, 768-69 (2d Cir. 1964) (securities broker misdeeds may violate Rule 10b-5 although same acts would not violate Rule 10b-5 if nonbroker were involved). See generally *JACOBS*, *supra* note 4, at § 210.01 (brokers held to higher standard than nonbrokers in judging whether broker actions violate Rule 10b-5); *JACOBS*, *supra* note 3, at 871 (same); *Langevoort*, *supra* note 4, at 1280 (same).

57. *Mansbach*, 598 F.2d at 1026.

58. *Id.* (Rule 10b-5 applies to broker's unauthorized trading in nondiscretionary customer account); see *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1520 (9th Cir. 1986) (unauthorized broker trading constitutes proper basis for claim under Rule 10b-5); *Smoky Greenhaw Cotton Co., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 785 F.2d 1274, 1277 (5th Cir. 1986) (unauthorized broker trading in nondiscretionary account is fraudulent scheme to which Rule 10b-5 applies); *Nye v. Blyth, Eastman, Dillon & Co.*, 588 F.2d 1189, 1197 (8th Cir. 1978) (unauthorized trading in nondiscretionary account, although customer has ratified broker trades, constitutes proper claim under Rule 10b-5). But see *Brophy v. Redivo*, 725 F.2d 1218, 1220 (9th Cir. 1984) (unauthorized trading alone does not support claim under Rule 10b-5); *Obrien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54, 61 (7th Cir. 1979) (unauthorized broker trading in discretionary account does not constitute basis for claim under Rule 10b-5); *Pross v. Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (unauthorized broker trading in nondiscretionary account is not within scope of Rule 10b-5); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1318 (E.D. Va. 1981) (Rule 10b-5 does not apply to unauthorized broker trading; plaintiff merely has claim for conversion or breach of contract under state law); *Cortlandt v. E.F. Hutton, Inc.*, 491 F. Supp. 1, 4 (S.D.N.Y. 1979) (unauthorized broker trading in discretionary account is basis for breach of contract claim only, and Rule 10b-5 does not apply); *Fein v. Shearson Hayden Stone, Inc.*, 461 F. Supp. 137, 142-43 (S.D.N.Y. 1978) (mere allegation of unauthorized broker trading in non-discretionary account is insufficient to state claim under Rule 10b-5); *Wassel v. A.G. Edwards & Sons, Inc.*, 425 F. Supp. 1205, 1207 (D. Md. 1977) (unauthorized broker trading does not constitute basis for claim under Rule 10b-5; plaintiff has claim only for conversion or breach

that the broker's refusal to return the customer's pledged bonds was a misappropriation of the customer's property that was inherently fraudulent.⁵⁹ The *Mansbach* court found that the customer's initial pledge of the bonds to the broker supplied the requisite purchase or sale for Rule 10b-5 applicability to the broker's act of conversion.⁶⁰ The Sixth Circuit thus implied that any acts of conversion of customer property by brokers are inherently fraudulent and, if in reckless disregard of the customers' interests, are sufficient bases for a Rule 10b-5 claim.⁶¹

of contract).

Several courts have found that Rule 10b-5 does not apply to unauthorized trading involving discretionary accounts. See *Obrien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54, 61 (7th Cir. 1979) (unauthorized broker trading in discretionary account does not constitute basis for claim under Rule 10b-5); *Cortlandt v. E.F. Hutton, Inc.*, 491 F. Supp. 1, 4 (S.D.N.Y. 1979) (unauthorized broker trading in discretionary account is basis for breach of contract claim only, Rule 10b-5 does not apply). Unauthorized broker trading in discretionary accounts is less egregious than unauthorized trading in nondiscretionary accounts because the customer delegates authority to the broker in a discretionary account, while the customer gives the broker authority to trade on behalf of the customer in a nondiscretionary account. See *JACOBS*, *supra* note 4, at § 212.01 (describing nature of discretionary account). An allegation that the broker traded customer securities without authority, therefore, is not proper when the customer has a discretionary account because trading is not truly unauthorized. *Id.* The distinction between discretionary and nondiscretionary accounts, therefore, is crucial to determining whether Rule 10b-5 should apply to unauthorized trading. *Id.* Several federal courts have failed to determine the nondiscretionary or discretionary nature of plaintiff customer accounts in judging the applicability of Rule 10b-5 to unauthorized trading. See *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513 (9th Cir. 1986) (failing to determine nondiscretionary or discretionary nature of customer accounts in determining applicability of Rule 10b-5 to unauthorized trading); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1318 (E.D. Va. 1981) (same); *Wassel v. A.G. Edwards & Sons, Inc.*, 425 F. Supp. 1205, 1207 (D. Md. 1977) (same); *infra* notes 181-86 and accompanying text (discussing relation of Rule 10b-5 fraud, manipulation or deception requirement to unauthorized broker trading in nondiscretionary as opposed to discretionary accounts).

59. *Mansbach*, 598 F.2d at 1027-28; see *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker's failure to disclose to customer that broker acted without authority in using customer property makes broker conversion of customer property inherently fraudulent), *cert. denied*, 461 U.S. 914 (1983); *Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980) (broker conversion of customer funds constitutes fraudulent scheme to which Rule 10b-5 applies), *modified on other grounds*, 640 F.2d 880 (7th Cir.), *cert. denied sub nom.*, *Smith, Barney, Harris, Upham & Co. v. Henricksen*, 454 U.S. 1097 (1981); *infra* notes 98-109 and accompanying text (discussing *United States v. Kendrick*). But see *Bosio v. Norbay Sec., Inc.* 599 F. Supp. 1563, 1567 (E.D.N.Y. 1985) (broker conversion of proceeds from sale of customer securities involves no misrepresentation or fraud, and therefore, Rule 10b-5 does not apply to broker conversion); *Smith v. Chicago Corp.*, 566 F. Supp. 66, 69 (N.D. Ill. 1983) (broker conversion of customer funds does not involve fraud, and therefore, Rule 10b-5 does not apply). See generally *Langevoort*, *supra* note 4, at 1256-57 n.43 (discussing whether misappropriation or conversion of property is fraudulent).

60. *Mansbach*, 598 F.2d at 1029. A pledge of securities is a sale for the purposes of satisfying the purchase-or-sale requirement of Rule 10b-5. See *Marine Bank v. Weaver*, 455 U.S. 551, 554 n.2 (1982) (pledge of securities is sale); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) (establishing purchase-or-sale requirement for Rule 10b-5 standing).

61. *Mansbach*, 598 F.2d at 1027; see *United States v. Kendrick*, 692 F.2d 1262, 1265-

The Sixth Circuit's permissive view, which recognizes Rule 10b-5 applicability to broker conversion of customer property, is popular among commentators, however, the permissive view does not have a wide following among the federal courts.⁶² In direct opposition to the Sixth Circuit's permissive view is the strict view favored by the United States Court of Appeals for the Second Circuit and the federal district courts within the Second Circuit. In *Pross v. Katz*⁶³, the defendant, an attorney and real estate developer, agreed to manage the plaintiff's investment in a limited partnership.⁶⁴ The defendant allegedly intended to convert the plaintiff's interest in the limited partnership to the defendant's own use at the time the defendant contracted with the plaintiff to manage the plaintiff's invest-

66 (9th Cir. 1982) (Rule 10b-5 applies to broker conversion of customer property), *cert. denied*, 461 U.S. 914 (1983); *Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980) (broker conversion of customer funds constitutes fraudulent scheme to which Rule 10b-5 applies), *modified on other grounds*, 640 F.2d 880 (7th Cir.), *cert. denied sub nom. Smith, Barney, Harris, Upham & Co. v. Henricksen*, 454 U.S. 1097 (1981). *But see* *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1517 (9th Cir. 1986) (Rule 10b-5 does not apply to broker conversion of customer securities); *Bold v. Simpson*, 802 F.2d 314, 320-21 (8th Cir. 1986) (Rule 10b-5 does not apply to conversion or theft of securities); *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) (Rule 10b-5 does not apply to conversion or theft of securities by fiduciary); *Miller v. Smith, Barney, Harris, Upham & Co.* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 92,498, at 93,031 (S.D.N.Y. 1986) (Rule 10b-5 does not apply to broker conversion of customer funds); *Bosio v. Norbay Sec., Inc.* 599 F. Supp. 1563, 1567 (E.D.N.Y. 1985) (broker conversion of proceeds from sale of customer securities involves no misrepresentation or fraud, and, therefore Rule 10b-5 does not apply to broker conversion); *Smith v. Chicago Corp.*, 566 F. Supp. 66, 69 (N.D. Ill. 1983) (broker conversion of customer funds does not involve fraud, and, therefore, Rule 10b-5 does not apply); *Erlbaum v. Erlbaum*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,772, at 93,920 (E.D. Pa. 1982) (broker conversion of customer securities is not proper basis for claim under Rule 10b-5); *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628, 636 (S.D.N.Y. 1977) (claim involving corporate conversion of cash using sham securities transaction does not fall within scope of Rule 10b-5), *aff'd*, 594 F.2d 852 (2d Cir. 1978).

Several cases find that Rule 10b-5 does not apply to conversions and thefts of property did not involve securities brokers as defendants. *See* *Bold v. Simpson*, 802 F.2d 314, 320-21 (8th Cir. 1986) (involving nonbroker defendant who reassigned to himself plaintiff's interest in oil lease); *Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986) (involving defendant attorney and real estate developer who converted plaintiff's interest in limited partnership); *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628, 632 (S.D.N.Y. 1977) (involving corporate director defendants who misappropriated cash from corporation using sham securities transaction), *aff'd*, 594 F.2d 852 (2d Cir. 1978). Situations that do not implicate securities brokers as defendants are distinguishable from situations that implicate brokers because Rule 10b-5 imposes higher standards of conduct upon brokers. *See supra* note 56 and accompanying text (discussing higher Rule 10b-5 standards for brokers than for nonbrokers).

62. *See Jacobs, supra* note 3, at 954-63 (Rule 10b-5 should apply to broker conversions of customer property); *Langevoort, supra* note 4, at 1279-83 (same); *see also supra* notes 58-61 and accompanying text (discussing conflicting federal court positions concerning applicability of Rule 10b-5 to broker conversions of customer property).

63. 784 F.2d 455 (2d Cir. 1986).

64. *Id.* at 457. An interest in a limited partnership is a security. *SEC v. Holschuh*, 694 F.2d 130, 137 (7th Cir. 1982); *see JACOBS, supra* note 4, at § 38.03(y) (examining status of limited partnership interest as security for purposes of Rule 10b-5).

ment.⁶⁵ The defendant also represented to the plaintiff that the defendant would manage the plaintiff's investments faithfully.⁶⁶ Despite the representations of good faith, however, the defendant allegedly procured through fraudulent means blank signature pages from the plaintiff and used the signatures to facilitate a transfer of the plaintiff's interest in the limited partnership to the defendant.⁶⁷ The plaintiff brought suit in the United States District Court for the Eastern District of New York.⁶⁸ The plaintiff asserted that the defendant had violated Rule 10b-5 when the defendant represented to the plaintiff that the defendant would manage the plaintiff's affairs faithfully, while the defendant actually intended to convert the plaintiff's interest in the limited partnership.⁶⁹ The plaintiff also claimed that the defendant had violated Rule 10b-5 when the defendant fraudulently obtained the plaintiff's signature and used the signature to effect a transfer of the plaintiff's interest in the limited partnership to the defendant without a corresponding transfer of consideration to the plaintiff.⁷⁰ The district court dismissed the plaintiff's complaint for failure to state a claim under Rule 10b-5.⁷¹

In considering the plaintiff's case on appeal from the district court, the United States Court of Appeals for the Second Circuit held that the plaintiff's allegations did not state a claim under Rule 10b-5.⁷² Although the case did not involve actions by a securities broker, the Second Circuit found that the defendant was acting in a fiduciary capacity in managing the plaintiff's investments.⁷³ The Second Circuit declared that the defendant's misrepresentation that the defendant would manage the plaintiff's investments fairly gave rise only to a claim for breach of fiduciary duty.⁷⁴ Furthermore, the Second Circuit noted that the conversion or theft of the plaintiff's securities did not state a Rule 10b-5 claim despite the defendant's status as a fiduciary.⁷⁵ The *Pross* court held that the conversion of the plaintiff's interest in the limited partnership did not constitute a purchase

65. *Pross*, 784 F.2d at 457.

66. *Id.*

67. *Id.*

68. *Id.* at 456.

69. *Id.* at 457.

70. *Id.*

71. *Id.* at 456. The district court in *Pross* found that the plaintiff's complaint stated only a claim for breach of contract, and not a claim under Rule 10b-5. *Id.* The district court's opinion is not officially reported. *Id.*

72. *Id.* at 459.

73. *Id.* The *Pross* court's determinations concerning the applicability of Rule 10b-5 to conversion of property by a fiduciary are relevant to questions concerning the applicability of Rule 10b-5 to conversion of property by brokers because securities brokers are fiduciaries. See *supra* note 56 and accompanying text (discussing status of broker as fiduciary to customer).

74. *Pross*, 784 F.2d at 458; see *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977) (claim for breach of fiduciary duty is not within scope of Rule 10b-5).

75. *Pross*, 784 F.2d at 459; see *supra* notes 58-61 and accompanying text (noting conflicting federal court decisions concerning applicability of Rule 10b-5 to conversion of property by fiduciaries and brokers).

or sale.⁷⁶ The Second Circuit, thus, refused to recognize the plaintiff's initial

76. *Pross*, 784 F.2d at 459 (conversion of securities does not constitute a sale of securities for purposes of Rule 10b-5); see *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1517 (9th Cir. 1986) (theft or conversion of securities does not qualify as sale for purposes of Rule 10b-5 standing); *Bold v. Simpson*, 802 F.2d 314, 320-21 (8th Cir. 1986) (Rule 10b-5 does not apply to conversion or theft of securities because conversion or theft is not sale); *Miller v. Smith, Barney, Harris, Upham & Co., Inc.* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 92,498, at 93,031 (S.D.N.Y. 1986) (broker conversion of customer funds has no connection to purchase or sale of securities); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1567 (E.D.N.Y. 1985) (broker conversion of proceeds from sale of customer securities involves no purchase or sale of securities, and, therefore, Rule 10b-5 does not apply to broker conversion); *Smith v. Chicago Corp.*, 566 F. Supp. 66, 69 (N.D. Ill. 1983) (no purchase or sale of securities occurs when broker converts customer funds); *Erlbaum v. Erlbaum*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,772, at 93,920 (E.D. Pa. 1982) (broker conversion of customer securities does not involve exchange of securities, and therefore, no purchase or sale occurs when broker converts customer securities); *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628, 636 (S.D.N.Y. 1977) (corporate conversion of cash using sham securities transaction is not within scope of Rule 10b-5 because no purchase or sale actually occurred), *aff'd*, 594 F.2d 852 (2d Cir. 1978). *But see* *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker conversion of customer funds in connection with customer pledge of securities satisfies purchase-or-sale requirement of Rule 10b-5), *cert. denied*, 461 U.S. 914 (1983); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1029 (6th Cir. 1979) (broker conversion of customer securities that customer had pledged satisfies purchase-or-sale requirement of Rule 10b-5); *Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980) (broker conversion of customer funds, coinciding with purchases of speculative securities for customer's account, satisfies purchase-or-sale requirement of Rule 10b-5), *modified on other grounds*, 640 F.2d 880 (7th Cir.), *cert. denied sub nom. Smith, Barney, Harris, Upham & Co. v. Henricksen*, 454 U.S. 1097 (1981).

The purchase-or-sale requirement of Rule 10b-5 poses a formidable barrier to claims involving broker conversion of customer funds. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975) (refusing to recognize standing under Rule 10b-5 for non-purchasers and non-sellers of securities). Unlike broker conversion of customer securities, broker conversion of customer funds does not implicate necessarily any transfer of customer securities. Customers might have funds on deposit with a broker, and, therefore, no sale of securities need occur for the broker to misappropriate customer funds. Federal courts that hold that broker conversion of customer funds is within the scope of Rule 10b-5 will connect the broker conversion of funds to a prior or contemporaneous purchase or sale of securities, thus satisfying the purchase-or-sale requirement of Rule 10b-5. See *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker conversion of customer funds in connection with prior customer pledge of securities satisfies purchase-or-sale requirement of Rule 10b-5), *cert. denied*, 461 U.S. 914 (1983); *Henricksen v. Henricksen*, 486 F. Supp. 622, 629 (E.D. Wis. 1980) (broker conversion of customer funds, coinciding with purchases of speculative securities for customer's account, satisfies purchase-or-sale requirement of Rule 10b-5), *modified on other grounds*, 640 F.2d 880 (7th Cir.), *cert. denied sub nom. Smith, Barney, Harris, Upham & Co. v. Henricksen*, 454 U.S. 1097 (1981). Federal courts that decline to hold that broker conversion of customer funds is within the scope of Rule 10b-5, however, will not create a causal nexus between broker conversions of cash and any prior or contemporaneous purchase or sale transactions in the customer's account. See *Miller v. Smith, Barney, Harris, Upham & Co., Inc.* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 92,498, at 93,031 (S.D.N.Y. 1986) (broker conversion of customer funds has no connection to purchase or sale of securities); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1567 (E.D.N.Y. 1985) (broker conversion of proceeds from sale of customer securities involves no purchase or sale of securities; sale generating misappropriated proceeds does not provide requisite sale for Rule 10b-5 purposes);

purchase of the limited partnership interest as the requisite purchase for Rule 10b-5 purposes.⁷⁷

In circumstances analogous to those in *Pross*, the United States District Court for the Southern District of New York addressed whether Rule 10b-5 applied to a broker's pledge of a customer's securities.⁷⁸ In *First Federal Savings and Loan Association of Pittsburgh v. Oppenheim, Appel, Dixon & Co.*,⁷⁹ several banks retained the services of a broker to trade in government securities.⁸⁰ The banks purchased securities and left the securities on deposit with the broker.⁸¹ The broker, although representing to the customer banks that the securities were in separate accounts, pledged the customers' securities to a third party lender as security for loans to the broker.⁸² The customers brought suit in federal district court, claiming Rule 10b-5 violations, against the broker's accountants for the accountant's alleged involvement in the broker's conversion of the customers' securities.⁸³

In addressing the plaintiffs' allegations, the district court in *First Federal* refused to recognize the plaintiff customers' standing as purchasers or sellers of securities.⁸⁴ The district court found that although the broker's pledge of the customers' securities was a sale for the purposes of Rule 10b-5, the broker's pledge of the customers' securities was not attributable to the plaintiff customers.⁸⁵ The district court held that in order to have standing

Smith v. Chicago Corp., 566 F. Supp. 66, 69 (N.D. Ill. 1983) (no purchase or sale of securities occurs when broker converts customer funds); see also *infra* notes 158-72 and accompanying text (discussing application of purchase-or-sale requirement to broker conversions of customer securities).

77. *Pross*, 784 F.2d at 459 (refusing to connect conversion of securities to prior purchase of securities by plaintiff). The *Pross* court's refusal to consider the plaintiff's initial purchase of securities as the requisite purchase or sale for Rule 10b-5 purposes directly conflicts with the position of the United States Court of Appeals for the Sixth Circuit in *Mansbach v. Prescott, Ball & Turben*. See *Mansbach*, 598 F.2d 1017 (6th Cir. 1979). In *Mansbach*, the Sixth Circuit found that the customer's initial pledge of securities was sufficient to supply the requisite purchase-or-sale to give the plaintiff standing for the broker conversion of the customer's securities that occurred approximately six months later. *Id.* at 1029. The *Pross* court, however, refused to recognize the plaintiff's purchases of securities in 1981 as the requisite purchases for Rule 10b-5 standing in an action concerning the defendant's conversion of the plaintiff's securities in 1983 and 1984. *Pross*, 784 F.2d at 456-57.

78. See *First Fed. Savings & Loan Ass'n of Pittsburgh v. Oppenheim, Appel, Dixon & Co.*, 629 F. Supp. 427 (S.D.N.Y. 1986) (holding that Rule 10b-5 does not apply to broker pledge of customer securities).

79. 629 F. Supp. 427 (S.D.N.Y. 1986).

80. *Id.* at 432.

81. *Id.*

82. *Id.*

83. *Id.* In *First Federal Savings & Loan Ass'n of Pittsburgh v. Oppenheim, Appel, Dixon & Co.*, a separate action against the broker was settled before the plaintiffs' suit against the accountants came before the district court. See *Wichita Fed. Savings & Loan Ass'n v. Comark*, 586 F. Supp. 940 (S.D.N.Y. 1985) (prior suit against broker, noting settlement of plaintiff's claim).

84. *First Federal*, 629 F. Supp. at 439; see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 751-55 (1975) (creating purchase-or-sale limitation on Rule 10b-5 standing).

85. *First Federal*, 629 F. Supp. at 439.

under Rule 10b-5, the customer had to be a pledgor or pledgee of the securities.⁸⁶ The district court thus barred all customer claims under Rule 10b-5 against a broker for unauthorized pledges of a customer's securities.⁸⁷

The United States District Court for the Southern District of New York continued the Second Circuit trend of strict denial of customer claims under Rule 10b-5 for broker conversions of customer property in *Pross v. Baird, Patrick & Co., Inc. (Baird)*.⁸⁸ In *Baird*, a customer had established a nondiscretionary securities trading account with the defendant broker.⁸⁹ The customer asserted that the broker had made purchases and sales in the customer's account that the customer had not authorized and that the unauthorized trading violated Rule 10b-5.⁹⁰ The district court, in finding that the plaintiff failed to state a claim under Rule 10b-5, did not focus on the purchase or sale requirement, but rather upon the manipulation or deception requirement of Rule 10b-5.⁹¹ The *Baird* court found that unauthorized trading in a nondiscretionary account did not inherently involve deception of the customer by the broker and, therefore, was not within the scope of Rule 10b-5.⁹² The district court opined that the plaintiff's allegations stated only a claim for breach of fiduciary duty or breach of contract.⁹³

86. *Id.* (broker pledge of customer securities is not attributable to customer for purpose of fulfilling purchase- or-sale requirement of Rule 10b-5). *But see* United States v. Kendrick, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker pledge of customer securities is attributable to customer), *cert. denied*, 461 U.S. 914 (1983); *see also* Securities Investor Protection Corp. v. Vigman, 803 F.2d 1513, 1519 n.2 (9th Cir. 1986) (noting that broker pledge of customer securities is attributable to customer, but also stating that customer did not have standing under Rule 10b-5 as purchaser or seller unless customer was actual pledgor or pledgee of securities).

87. *First Federal*, 629 F. Supp. at 439 (Rule 10b-5 does not apply to broker pledge of customer securities). *But see* United States v. Kendrick, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker pledge of customer securities is within scope of Rule 10b-5), *cert. denied*, 461 U.S. 914 (1983); *see also* Securities Investor Protection Corp. v. Vigman, 803 F.2d 1513, 1519 n.2 (9th Cir. 1986) (noting that broker pledge of customer securities is within scope of Rule 10b-5, but also stating that customer did not have standing under Rule 10b-5 as purchaser or seller unless customer was actual pledgor or pledgee of securities).

88. 585 F. Supp. 1456 (S.D.N.Y. 1984).

89. *Id.* at 1458; *see also supra* note 50 (distinguishing between non-discretionary and discretionary trading accounts).

90. *Baird*, 585 F. Supp. at 1458.

91. *Id.* at 1458-59; *see* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) (establishing fraud, manipulation or deception requirement, which serves to restrict scope of Rule 10b-5).

92. *Baird*, 585 F. Supp. at 1460 (broker unauthorized trading in nondiscretionary account is not inherently deceptive); *see also supra* notes 57-58 and accompanying text (discussing conflicting federal court positions concerning applicability of Rule 10b-5 to unauthorized trading).

93. *Baird*, 585 F. Supp. at 1460 (unauthorized trading implicates no Rule 10b-5 claim; plaintiff only has claim for breach of contract or breach of fiduciary duty). In finding that unauthorized trading does not fall within the scope of Rule 10b-5, the *Baird* court implied that unauthorized trading claims were similar in nature to claims involving broker refusal to execute trades that the customer had ordered. *Id.*; *see* Securities Investor Protection Corp. v.

The district court thus ruled that all claims involving unauthorized trading were outside the scope of Rule 10b-5 unless a broker actively deceives a customer by representing to the customer that trading in the customer's account is authorized when the trading is actually unauthorized.⁹⁴

The decisions in *Pross*, *First Federal*, and *Baird* demonstrate the hostility of Second Circuit courts to the application of Rule 10b-5 to broker conversions of customer property.⁹⁵ The United States Court of Appeals for the Ninth Circuit, however, has been more flexible than the Second Circuit, allowing Rule 10b-5 claims for some broker conversions of customer property, but dismissing Rule 10b-5 claims for certain other broker conversions.⁹⁶ The Ninth Circuit has attempted to distinguish among various acts of conversion.⁹⁷ In *United States v. Kendrick*,⁹⁸ a broker appealed to the

Vigman, 803 F.2d 1513, 1518 (9th Cir. 1986) (broker's refusal to execute trades that customer orders broker to make does not give rise to Rule 10b-5 claim; rather, customer only has claim for breach of fiduciary duty); *Forkin v. Rooney Pace, Inc.*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 94,982, at 94,819-20 (8th Cir. 1986) (broker refusal to rescind sale on customer order involves only breach of contract claim, and not Rule 10b-5 claim); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (broker's failure to sell securities, contrary to agreement with customer that broker would sell securities in customer's account, involves only breach of contract claim, and not Rule 10b-5 claim); *Smith v. Chicago Corp.*, 566 F. Supp. 66, 69-70 (N.D. Ill. 1983) (Rule 10b-5 does not apply to broker refusal to execute trades that customer requested); *Zerman v. Jacobs*, 510 F. Supp. 132, 135 (S.D.N.Y. 1981) (broker sale of customer securities, contrary to agreement with customer not to sell, does not implicate Rule 10b-5; customer has only breach of contract claim); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1318 (E.D. Va. 1981) (broker refusal to sell on customer's order is breach of contract claim only). Unauthorized broker trading in a customer's nondiscretionary account, however, involves deception. See *infra* notes 181-86 and accompanying text (discussing deceptive nature of unauthorized trading in nondiscretionary account). Broker refusal to execute customer-ordered trades, however, does not involve deception. See cases cited *supra* (finding broker refusal to trade securities on customer's order not deceptive act within scope of Rule 10b-5). When a broker refuses to execute a trade that the customer has ordered, the customer is aware of the status of the customer's account at all times. Unauthorized trading, in contrast, involves broker activities of which the customer has no knowledge as the activity takes place. Unauthorized trading thus implies deception of the customer because the broker fails to disclose to the customer that the broker is trading in the customer's account without authority. See *infra* notes 181-86 and accompanying text (discussing deception involved in unauthorized trading in nondiscretionary account). Unlike broker refusal to execute customer-ordered trades, unauthorized trading should not give rise only to a breach of contract or breach of fiduciary duty claim, but should implicate a Rule 10b-5 claim. See *supra* notes 57-58 and accompanying text (discussing conflicting federal court decisions concerning applicability of Rule 10b-5 to unauthorized trading).

94. *Baird*, 585 F. Supp. at 1460.

95. See *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) (Rule 10b-5 does not apply to theft or conversion of securities by fiduciary); *First Fed. Savings & Loan Ass'n v. Oppenheim, Appel, Dixon & Co.*, 629 F. Supp. 427, 439 (S.D.N.Y. 1986) (Rule 10b-5 does not apply to unauthorized broker pledge of customer securities); *Pross v. Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (Rule 10b-5 does not apply to unauthorized broker trading).

96. See *infra* notes 98-138 and accompanying text (discussing Ninth Circuit cases concerning the applicability of Rule 10b-5 to broker conversions).

97. See *infra* notes 98-138 and accompanying text (discussing Ninth Circuit cases concerning applicability of Rule 10b-5 to broker conversion of customer property).

98. 692 F.2d 1262 (9th Cir. 1982).

Ninth Circuit his conviction in the United States District Court for the Northern District of California for violations of Rule 10b-5.⁹⁹ The broker allegedly had converted funds from customer accounts with a third party broker by using unauthorized drafts on the customer accounts.¹⁰⁰ The broker also allegedly had procured loans from the third party broker using as collateral customer securities that the customers had pledged to the third party broker.¹⁰¹ Furthermore, the defendant broker allegedly told the customers that the withdrawals of cash were for the purpose of purchasing securities, and the broker did not disclose to the customers that the broker had used the customers' securities as collateral for loans to the broker.¹⁰²

In affirming the broker's conviction, the Ninth Circuit found that both the broker's conversion of the customers' cash and the broker's use of the customers' securities as collateral for loans to the broker violated Rule 10b-5.¹⁰³ The *Kendrick* court declared that the pledge of securities to the third party broker supplied the requisite purchase or sale for Rule 10b-5 purposes.¹⁰⁴ The Ninth Circuit noted that the broker had not made a new pledge of the customers' securities in procuring the loan from the third party broker but that the absence of a new pledge was irrelevant.¹⁰⁵ The *Kendrick* court held that a sale occurred when, as a result of the loan, the defendant broker gave the third party broker an additional interest in the customers' securities.¹⁰⁶ Furthermore, the Ninth Circuit opined that the acts of conversion were fraudulent.¹⁰⁷ The *Kendrick* court determined that the defendant's failure to disclose that the defendant was acting without authority in converting the customers' property was fraudulent.¹⁰⁸ The *Kendrick* court thus ruled that Rule 10b-5 applied to the broker conversion of customer cash, which was essentially theft, and to the broker's unauthorized use of customer securities as collateral for loans to the broker.¹⁰⁹

99. *Id.* at 1263. No reported information exists concerning the findings of law that the district court in *Kendrick* made during the trial and pursuant to the conviction of the defendant. *Id.*

100. *Id.* at 1264.

101. *Id.*

102. *Id.* at 1264-65.

103. *Id.* at 1265-66; see *supra* notes 59-61 & 76 and accompanying text (discussing conflicting federal court decisions concerning applicability of Rule 10b-5 to broker conversion of customer funds); *supra* notes 86-87 and accompanying text (discussing conflicting federal court decisions concerning applicability of Rule 10b-5 to broker pledge of customer securities).

104. *Kendrick*, 692 F.2d at 1265 (broker pledge of customer securities is attributable to customer for purposes of satisfying purchase-or-sale requirement of Rule 10b-5); see *supra* notes 86-87 and accompanying text (discussing conflicting federal court decisions concerning attribution of broker pledge of customer securities to customer).

105. *Kendrick*, 692 F.2d at 1265.

106. *Id.*

107. See *id.* (broker conversion of customer property is inherently fraudulent); see also *supra* note 59 and accompanying text (discussing fraudulent nature of broker conversions of customer property).

108. *Kendrick*, 692 F.2d at 1265-66.

109. *Id.* at 1265.

Despite finding in *Kendrick* that broker conversion of customer property was within the scope of Rule 10b-5, the Ninth Circuit has not been consistent in allowing Rule 10b-5 claims involving broker conversions of customer property. In *Securities Investor Protection Corporation v. Vigman*,¹¹⁰ the Securities Investor Protection Corporation (SIPC),¹¹¹ as subrogee to broker customer claims,¹¹² alleged that the defendant brokers had converted customer property in a number of ways.¹¹³ The defendant brokers, aided by corporate and individual defendants, allegedly had engaged in a scheme to manipulate the stock prices of several corporations.¹¹⁴ The exposure of the scheme led to the insolvency of the brokerage firms, and upon liquidation of the brokerage firms, the trustee found that customer securities and cash were missing.¹¹⁵ SIPC alleged that the defendant brokers had stolen customer securities and cash and had pledged customer securities to broker creditors.¹¹⁶ SIPC also alleged that the brokers had conducted unauthorized trading in customer accounts.¹¹⁷ The United States District Court for the Central District of California dismissed SIPC's complaint for failure to state a claim under Rule 10b-5.¹¹⁸

On appeal, the United States Court of Appeals for the Ninth Circuit held that simple conversions and thefts of customer property were not within

110. 803 F.2d 1513 (9th Cir. 1986).

111. See Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (1970) (amended 1978, 1980). The Securities Investor Protection Act (SIPA) created the Securities Investor Protection Corporation (SIPC), a nonprofit membership corporation, to provide protection to broker customers in the event of broker insolvency. *Id.* § 78ccc. SIPC membership consists of nationally registered securities brokers and dealers. *Id.* § 78ccc(2)(a). SIPA requires SIPC to establish a fund to satisfy customer claims against the insolvent broker through assessments upon SIPC members. *Id.* § 78ddd. The SIPC fund is supplemented by up to \$1 billion that SIPC may borrow from the United States Treasury. *Id.* § 78ddd(f)-(h). A proceeding under SIPA involves liquidation of the insolvent broker. *Id.* § 78fff(a). A SIPC trustee satisfies customer claims against the defendant broker for the value of the customer's security and cash positions that the broker was supposed to have on hand at the time the SIPA liquidation proceeding commenced. *Id.* §§ 78fff, 78fff-3. SIPC satisfies customer claims to the greatest extent possible by using available assets of the broker. *Id.* § 78fff-2(c). To the extent that broker assets are insufficient, SIPC disburses cash or market-purchased securities to satisfy customer claims. *Id.* §§ 78fff-2(d), 78fff-3(a). SIPC may not advance more than \$500,000 of SIPC funds to cover customer claims for securities on deposit with the broker, and no more than \$100,000 to satisfy customer losses of cash. *Id.* § 78fff-3(a). To the extent that SIPC satisfies customer claims out of SIPC funds, SIPC is subrogee to any related claims that the customers have against the insolvent broker or third parties. *Id.* § 78fff-3(a).

112. See *supra* note 111 (discussing nature of SIPC subrogation rights).

113. *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1519 (9th Cir. 1986).

114. *Id.* at 1515.

115. *Id.*

116. *Id.* at 1519.

117. *Id.*

118. *Id.* at 1515. The district court in *Vigman* held that SIPC, and therefore the broker customers, lacked standing under Rule 10b-5 as purchasers or sellers of securities. *Id.* at 1516. The district court's opinion is not officially reported. *Id.* at 1515.

the scope of Rule 10b-5.¹¹⁹ The *Vigman* court determined that the purchase-or-sale requirement of Rule 10b-5 was not satisfied.¹²⁰ The Ninth Circuit, however, made conflicting statements concerning the Rule 10b-5 status of the broker pledges of customer securities.¹²¹ While stating that the customers lacked standing under Rule 10b-5 for the broker pledges of customer securities because the customers themselves were not pledgors of the securities, the Ninth Circuit also noted that unauthorized broker pledges of customer securities were attributable to the customer for the purpose of meeting the purchase-or-sale requirement.¹²² The Ninth Circuit additionally found that Rule 10b-5 applied to unauthorized trading in customer accounts.¹²³ The *Vigman* court found that the brokers' unauthorized trading in customer accounts was attributable to the customer, thus fulfilling the purchase-or-sale requirement of Rule 10b-5.¹²⁴ The *Vigman* court noted that allowing Rule 10b-5 claims for unauthorized trading would not implicate any of the practical concerns that the United States Supreme Court discussed in *Blue Chip Stamps*.¹²⁵

Standing in apparent contradiction to the Ninth Circuit's opinion in *Vigman* concerning unauthorized trading, however, is the Ninth Circuit's opinion in *Brophy v. Redivo*.¹²⁶ In *Brophy* a customer granted authority to

119. *Id.*; see *supra* notes 59-61 and accompanying text (discussing conflicting federal court positions concerning applicability of Rule 10b-5 to broker conversions and thefts of customer property).

120. *Vigman*, 803 F.2d at 1519; see *supra* note 76 and accompanying text (discussing status of conversion of securities as purchase or sale for purposes of Rule 10b-5 standing).

121. *Vigman*, 803 F.2d at 1519.

122. *Id.*; see *supra* notes 86-87 and accompanying text (discussing federal court decisions concerning attribution of broker pledge of customer securities to customer for purposes of satisfying purchase-or-sale requirement of Rule 10b-5).

123. *Vigman*, 803 F.2d at 1519.

124. *Id.* Whether unauthorized trading by a broker should be attributable to the customer generally is not an issue in Rule 10b-5 unauthorized trading cases; federal courts uniformly assume that the customer has standing as purchaser or seller for broker trades conducted in the customer's account. See *Smoky Greenhaw Cotton Co. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 785 F.2d 1274, 1277 (5th Cir. 1986) (assuming, without expressly stating, that customer has standing under Rule 10b-5 as purchaser or seller of securities for unauthorized trading by broker); *Brophy v. Redivo*, 725 F.2d 1218, 1220 (9th Cir. 1984) (same); *Obrien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54, 61 (7th Cir. 1979) (same); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979) (same); *Nye v. Blyth, Eastman, Dillon & Co.*, 588 F.2d 1189, 1197 (8th Cir. 1978) (same); *Pross v. Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (same); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1318 (E.D. Va. 1981) (same); *Cortlandt v. E.F. Hutton, Inc.*, 491 F. Supp. 1, 4 (S.D.N.Y. 1979) (same); *Fein v. Shearson Hayden Stone, Inc.*, 461 F. Supp. 137, 142-43 (S.D.N.Y. 1978) (same); *Wassel v. A.G. Edwards & Sons, Inc.*, 425 F. Supp. 1205, 1207 (D. Md. 1977) (same).

125. *Vigman*, 803 F.2d at 1520; see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735-55 (1975) (enumerating practical reasons for denying Rule 10b-5 standing to non-purchasers and nonsellers of securities); *supra* text accompanying notes 25-31 (discussing the practical reasons for denying standing to non-purchasers or sellers in *Blue Chip Stamps v. Manor Drug Stores*).

126. 725 F.2d 1218 (9th Cir. 1984).

a broker to trade on any positions in the customer's nondiscretionary account that became "dangerous" while the customer was away on a one-month vacation.¹²⁷ Upon returning from vacation, the customer noted a number of trades in the customer's account that the customer felt were unauthorized.¹²⁸ Six months after the discovery, the customer asserted that the broker violated Rule 10b-5 when the broker engaged in unauthorized trading in the customer's account.¹²⁹ The United States District Court for the District of Arizona, in directing a verdict for the defendant, found that unauthorized trading did not violate Rule 10b-5.¹³⁰ Affirming the district court's decision, the Ninth Circuit asserted that unauthorized trading alone did not support a claim under Rule 10b-5.¹³¹ The *Brophy* court held that the customer's Rule 10b-5 claim failed because the unauthorized trading did not involve fraud, manipulation, or deception and because the customer failed to show that the broker acted in reckless disregard for the customer's interests.¹³² Significant to the *Brophy* court's decision were the facts that the customer had profited from the unauthorized trading and that the customer had failed to complain about the unauthorized trading for six months.¹³³

As a result of the Ninth Circuit's opinions in *Kendrick*, *Vigman*, and *Brophy*, the law in the Ninth Circuit under Rule 10b-5 concerning broker conversions is unclear.¹³⁴ The Ninth Circuit's attempts to distinguish between various acts of conversion have been unsuccessful.¹³⁵ The holdings in *Vigman* and *Kendrick* conflict on the question of Rule 10b-5 applicability to simple conversions and thefts of customer property.¹³⁶ The Ninth Circuit's opinions in *Vigman* and *Brophy* conflict on the question of Rule 10b-5 applicability to unauthorized broker trading in customer accounts.¹³⁷ Finally, the Ninth

127. *Id.* at 1221.

128. *Id.*

129. *Id.*

130. *Id.* at 1220.

131. *Id.*; see *supra* note 58 and accompanying text (discussing conflicting federal court decisions concerning applicability of Rule 10b-5 to unauthorized trading).

132. *Brophy*, 725 F.2d at 1220-21.

133. *Id.* at 1221.

134. See *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1519-20 (9th Cir. 1986) (Rule 10b-5 does not apply to broker theft or conversion of customer securities, but Rule 10b-5 applies to unauthorized broker pledge of customer securities and to unauthorized broker trading); *Brophy v. Redivo*, 725 F.2d 1218, 1220 (9th Cir. 1984) (unauthorized trading alone does not support Rule 10b-5 claim); *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (Rule 10b-5 applies to broker conversion of customer funds and to unauthorized broker pledge of customer securities), *cert. denied*, 461 U.S. 914 (1983).

135. See *supra* notes 96-133 and accompanying text (discussing Ninth Circuit decisions concerning the applicability of Rule 10b-5 to broker conversion of customer property).

136. Compare *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1519 (9th Cir. 1986) (broker conversion or theft of customer property is not within scope of Rule 10b-5); with *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker conversion of customer property is within scope of Rule 10b-5), *cert. denied*, 461 U.S. 914 (1983).

137. Compare *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1520 (9th

Circuit's ruling in *Vigman* is internally inconsistent on the applicability of Rule 10b-5 to broker pledges of customer securities.¹³⁸

In addition to the confusion in the Ninth Circuit concerning the applicability of Rule 10b-5 to broker conversions of customer property, a conflict exists between the Sixth Circuit and the Second Circuit.¹³⁹ The Sixth Circuit's permissive view, which allows Rule 10b-5 claims for all types of broker conversion, directly opposes the Second Circuit's strict view, which rejects all Rule 10b-5 claims involving broker conversion.¹⁴⁰ The existing conflict among federal courts demands a uniform resolution in order to eliminate confusion concerning the applicability of Rule 10b-5 to broker conversion of customer property. A desirable resolution of the confusion would provide that Rule 10b-5 apply to broker thefts and misappropriations of securities from customer accounts.¹⁴¹ Rule 10b-5 also should apply to broker pledges of customer securities.¹⁴² Finally, Rule 10b-5 should apply to unauthorized broker trading in customers' nondiscretionary trading accounts.¹⁴³ The permissive view, applying Rule 10b-5 to broker conversion of customer property, is thus more desirable than the strict view.¹⁴⁴

An underlying premise to the superiority of the permissive view is the impropriety of attempts to distinguish among various broker conversions of customer property.¹⁴⁵ The confusion that the Ninth Circuit has created in attempting to distinguish among various acts of conversion demonstrates the difficulty in making distinctions.¹⁴⁶ A broker's pledge of a customer's securities essentially involves a broker's unauthorized use of customer prop-

Cir. 1986) (broker unauthorized trading is within scope of Rule 10b-5); *with Brophy v. Redivo*, 725 F.2d 1218, 1220 (9th Cir. 1984) (Rule 10b-5 does not apply to broker unauthorized trading).

138. See *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1519 (9th Cir. 1986) (stating that broker pledge of customer securities is not within scope of Rule 10b-5, but also noting that customer has claim under Rule 10b-5 for broker pledge of customer securities).

139. See *supra* notes 46-95 and accompanying text (discussing conflicting positions of Second Circuit and Sixth Circuit concerning applicability of Rule 10b-5 to broker conversions of customer property).

140. See *supra* notes 47-62 and accompanying text (discussing Sixth Circuit's permissive view regarding applicability of Rule 10b-5 to broker conversion of customer property); *supra* notes 63-95 and accompanying text (discussing Second Circuit's strict view regarding applicability of Rule 10b-5 to broker conversion of customer property).

141. See *infra* notes 145-203 and accompanying text (providing support for Rule 10b-5 applicability to broker thefts and misappropriations of customer securities).

142. See *infra* notes 145-203 and accompanying text (providing support for Rule 10b-5 applicability to broker pledges of customer securities).

143. See *infra* notes 145-203 and accompanying text (providing support for Rule 10b-5 applicability to unauthorized broker trading in customer nondiscretionary trading accounts).

144. See *supra* notes 46-95 and accompanying text (discussing aspects of strict and permissive views concerning Rule 10b-5 applicability to broker conversions of customer property).

145. See *infra* notes 146-56 and accompanying text (discussing reasons why distinguishing among various acts of conversion by brokers is improper).

146. See *supra* notes 96-138 and accompanying text (discussing Ninth Circuit's attempts to distinguish among various acts of conversion in determining applicability of Rule 10b-5).

erty.¹⁴⁷ No benefit accrues to the customer as a result of the broker's pledge.¹⁴⁸ Similarly, a broker's unauthorized trading in a customer's non-discretionary account involves the unauthorized use of customer property.¹⁴⁹ In circumstances involving unauthorized trading, the customer receives consideration for which the customer did not bargain.¹⁵⁰ When a broker steals or misappropriates customer securities, the broker takes and uses customer property without authority and without giving consideration to the customer.¹⁵¹ Furthermore, each act of conversion directly interferes with the customer's interests.¹⁵² The broker's pledge violates the customer's interest in preserving the value and integrity of the customer's securities.¹⁵³ Unauthorized trading in a customer's nondiscretionary account violates the customer's interest in maintaining control over transactions affecting the customer's account.¹⁵⁴ Theft and misappropriation violate the customer's basic property interests.¹⁵⁵ Unauthorized trading in nondiscretionary accounts, pledges of customer securities, and thefts and misappropriations of customer securities, thus, each involve unauthorized use of customer property, for no consideration, or for unbargained-for consideration, and are acts contrary to customer interests.¹⁵⁶ In judging the applicability of Rule 10b-5, therefore, distinctions between acts of conversion are improper. The federal courts, therefore, uniformly should apply, or refuse to apply, Rule 10b-5 to broker conversions of customer property.

In determining whether or not Rule 10b-5 should apply to broker conversion of customer property, however, federal courts have struggled with the fraud, manipulation, or deception requirement and with the purchase-or-sale requirement.¹⁵⁷ In addressing the purchase-or-sale requirement, federal courts have questioned whether a customer has standing under Rule 10b-5 as a purchaser or seller for transactions that a broker conducts.¹⁵⁸

147. See PROSSER, *supra* note 6, at 90 (conversion involves defendant's exercise of dominion or control over property in manner inconsistent with rights of property's owner; thus, pledge of property without authority is conversion).

148. *Cf. id.* (conversion involves transfer or use of property without corresponding consideration flowing to property owner).

149. See *id.* (unauthorized use of property is conversion, and broker unauthorized trading, therefore, is conversion).

150. *Cf. id.* (unauthorized use of property is conversion and involves unilateral action by defendant).

151. See *id.* (theft of property is conversion).

152. See *id.* (conversion involves exercise of dominion or control over property that is inconsistent with property owner's rights).

153. *Cf. id.* at 96 (unauthorized pledge of property is conversion).

154. *Cf. id.* at 90 (unauthorized use of property is conversion).

155. *Cf. id.* (theft of property is conversion).

156. See *supra* notes 147-55 and accompanying text (discussing characterization of unauthorized trading, unauthorized pledges and thefts of securities as acts of conversion).

157. See *infra* notes 159-86 and accompanying text (discussing application of purchase-or-sale and fraud, manipulation or deception requirements to broker conversions of customer property).

158. See *infra* notes 159-72 and accompanying text (discussing application of purchase-or-sale requirement to broker conversions of customer property).

Under *Blue Chip Stamps*, if the Rule 10b-5 plaintiff is not a purchaser or seller of securities, the plaintiff does not have a Rule 10b-5 claim.¹⁵⁹ The status, however, of the plaintiff customer as a purchaser or seller of securities in unauthorized trading cases is not an issue.¹⁶⁰ Federal courts uniformly attribute the broker's transactions in the customer's account to the customer, thus satisfying the purchase-or-sale requirement of Rule 10b-5.¹⁶¹ In cases involving broker pledges of customer securities, however, federal courts have questioned the customer's status as purchaser or seller of securities.¹⁶² All broker transactions involving customer property should be attributable to the customer for the purposes of fulfilling the purchase-or-sale requirement of Rule 10b-5. The customer's property is the subject of the broker's transactions and, therefore, the customer is a party to the broker's dispositions of the customer's property even though the customer has no knowledge of the transactions. Furthermore, as the customer's agent in managing the customer's investments, the broker acts on behalf of the customer whenever the broker performs any act involving the customer's property.¹⁶³ The failure to attribute the broker's actions concerning the customer's property to the customer, therefore, constitutes an artificial restriction upon the scope of Rule 10b-5.

In addition to the problem regarding the attribution of broker transactions to the customer, the purchase-or-sale requirement is not readily adaptable to the application of Rule 10b-5 to broker thefts or misappropriations of customer securities.¹⁶⁴ A broker theft or misappropriation of customer securities is a transfer of the customer's property without consideration.¹⁶⁵ Because a sale for Rule 10b-5 purposes does not necessarily entail consideration flowing to the seller, federal courts should characterize broker thefts of customer securities as sales.¹⁶⁶ Furthermore, broker pledges of

159. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727 (1975) (plaintiff has no standing under Rule 10b-5 unless plaintiff is purchaser or seller of securities).

160. See *supra* notes 123-24 and accompanying text (discussing attribution of broker trades to customer for purposes of satisfying purchase-or-sale requirement of Rule 10b-5 in unauthorized trading situations).

161. See *supra* notes 123-24 and accompanying text (discussing attribution of broker trades to customer for purposes of fulfilling purchase-or-sale requirement of Rule 10b-5 in unauthorized trading situations).

162. See *supra* notes 86-87 and accompanying text (discussing conflicting federal court positions concerning attribution of broker pledge of customer securities to customer for purposes of satisfying purchase-or-sale requirement of Rule 10b-5).

163. See *JACOBS, supra* note 4, at § 210 (broker is customer's agent and fiduciary with respect to management of customer's account).

164. See *supra* note 76 and accompanying text (discussing status of broker conversion or theft as purchase-or-sale for purposes of Rule 10b-5 standing).

165. See *JACOBS, supra* note 4, at § 116.02 n.10 (theft of securities is sale without consideration).

166. See *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 437 (5th Cir. 1980) (transfer of securities for worthless consideration is sale for purposes of Rule 10b-5 standing); *Int'l Controls Corp. v. Vesco*, 490 F.2d 1334, 1346 (2d Cir.) (no consideration need flow to seller for sale to occur under Rule 10b-5), *cert. denied*, 417 U.S. 932 (1974); *Rekant v. Dessler*, 425 F.2d

customer securities are basically thefts of all or a part of the value of the customer's securities.¹⁶⁷ When a broker pledges a customer's securities, the broker impairs the value of the customer's securities without giving corresponding consideration to the customer.¹⁶⁸ Because a pledge of securities is a sale,¹⁶⁹ and because a broker pledge of customer securities must be attributable to the customer,¹⁷⁰ the broker pledge of customer securities fulfills the purchase-or-sale requirement of Rule 10b-5.¹⁷¹ Because a broker pledge is a theft of the value to the customer of securities as collateral, a broker theft or misappropriation of customer securities likewise should satisfy the purchase-or-sale requirement. Due to the attribution of broker conversions to the customer and the classification of broker thefts of customer securities as a sale, broker conversions of customer property fulfill the purchase-or-sale requirement of Rule 10b-5.¹⁷²

The purchase-or-sale requirement of Rule 10b-5, however, exists in conjunction with the fraud, manipulation, or deception requirement.¹⁷³ A plaintiff must meet both requirements to state a valid claim under Rule 10b-5.¹⁷⁴ A broker, however, deceives a customer when the broker converts customer property because the broker fails to disclose to the customer that the broker is using the customer's property without authorization.¹⁷⁵ Moreover, the broker has a fiduciary duty to the customer to disclose material information to the customer regarding the management of the customer's investment account.¹⁷⁶ The position of trust that the broker occupies inherently implies a representation to the customer that the broker will manage

872, 876 & 881 (5th Cir. 1970) (transfer of securities for no consideration is sale); *Murphey v. Hillwood Villa Assoc.*, 411 F. Supp. 287, 293 (S.D.N.Y. 1976) (no consideration need flow to seller for sale to occur under Rule 10b-5); *see also* JACOBS, *supra* note 4, at § 38.02(b) (broker theft of customer securities should constitute sale for purposes of Rule 10b-5 standing).

167. *See* JACOBS, *supra* note 4, at § 213 (broker pledge of customer securities is misappropriation or theft of customer property).

168. *See id.* (broker pledge of customer securities involves taking of customer property without consideration to customer).

169. *See supra* note 60 and accompanying text (discussing status of pledge of securities as sale for purposes of Rule 10b-5 standing).

170. *See supra* notes 86-87 and accompanying text (discussing conflicting federal court positions concerning attribution of broker pledge of customer securities to customer for purposes of satisfying purchase-or-sale requirement of Rule 10b-5).

171. *See supra* notes 86-87 and accompanying text (discussing applicability of Rule 10b-5 to broker pledge of customer securities).

172. *See supra* notes 164-71 and accompanying text (discussing status of broker theft of customer securities as sale of securities for purposes of Rule 10b-5 standing).

173. *See supra* note 17 and accompanying text (discussing elements of Rule 10b-5 claim).

174. *See supra* notes 15-42 and accompanying text (discussing purchase-or-sale requirement and fraud, manipulation, or deception requirement).

175. *See* *United States v. Kendrick*, 692 F.2d 1262, 1265-66 (9th Cir. 1982) (broker use of customer property without authority and without disclosure of lack of authority is deceptive), *cert. denied*, 461 U.S. 914 (1983).

176. *See* JACOBS, *Impact of Rule 10b-5*, *supra* note 3, at 871-81 (broker is fiduciary of customer and has duty to customer to disclose material information relevant to management of customer's account).

the customer's account in good faith.¹⁷⁷ A conversion of customer property, therefore, necessarily involves a broker's misrepresentation of good faith.¹⁷⁸ Broker conversions of customer property, therefore, are deceptive.¹⁷⁹ Broker conversions thus satisfy the fraud, manipulation, or deception requirement of Rule 10b-5.¹⁸⁰

In determining the applicability of Rule 10b-5 to broker conversions of customer property, federal courts most often contend with the fraud, manipulation, or deception requirement of Rule 10b-5 in cases of unauthorized trading.¹⁸¹ Problems arise because federal courts often fail to distinguish between allegations of unauthorized trading in nondiscretionary accounts and allegations of unauthorized trading in discretionary accounts.¹⁸² Trading in discretionary accounts is not deceptive, absent churning,¹⁸³ because the customer has delegated authority to the broker to make investment decisions.¹⁸⁴ The broker, therefore, cannot deceive the customer because no

177. See *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943) (broker, by taking customer business, impliedly represents to customer that broker will deal with customer fairly), *cert. denied*, 321 U.S. 786 (1944). The implied representation that a broker will deal with customers fairly is termed the "shingle theory". See *JACOBS*, *supra* note 4, at §210.03 (describing shingle theory); *JACOBS*, *supra* note 3, at 876-81 (same); *Langevoort*, *supra* note 4, at 1280 (same). The term "shingle theory" derives from the concept that merely by going into business as a broker, "hanging out his shingle", a broker represents to customers that the broker will deal with customers fairly. See *JACOBS*, *supra* note 4, at § 210.03 (describing derivation of term "shingle theory"); *JACOBS*, *supra* note 3, at 876 (same). The shingle theory is an extremely broad basis for the establishment of fraud or deception in connection with broker management of customer accounts because any unfair dealing with the customer involves a misrepresentation or deception of the customer under Rule 10b-5. See *JACOBS*, *supra* note 4, at § 210.03 (describing breadth of shingle theory); *JACOBS*, *supra* note 3, at 876-81 (same).

178. See *JACOBS*, *supra* note 4, at § 213 (broker conversions involve misrepresentation by broker because conversions are not consistent with representation of good faith dealing that broker makes to customer).

179. See *supra* note 59 and accompanying text (discussing conflicting federal court decisions concerning fraud, manipulation, or deception involved in broker conversion of customer property).

180. See *supra* notes 59 and accompanying text (discussing conflicting federal court decisions concerning fraud, manipulation, or deception involved in broker conversion of customer property).

181. See *supra* notes 58-59 and accompanying text (discussing application of fraud, manipulation, or deception requirement to unauthorized trading cases).

182. See *supra* note 58 and accompanying text (discussing cases in which federal courts have failed to determine or to consider nondiscretionary or discretionary nature of customer accounts in determining applicability of Rule 10b-5 to unauthorized broker trading).

183. See *e.g.* *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984) (churning violates Rule 10b-5); *Petrites v. J.C. Bradford & Co.*, 646 F.2d 1033, 1035 (5th Cir. 1981) (same); *Mihara v. Dean Witter & Co.*, 619 F.2d 811, 814 (9th Cir. 1980) (same). Churning involves excessive trading in a customer account for the purpose of generating broker commissions and contrary to the customer's investment objectives. See *JACOBS*, *supra* note 4, at § 212.01 (discussing churning as basis for claim under Rule 10b-5); *JACOBS*, *supra* note 3, at 829-36 (same); *Langevoort*, *supra* note 4, at 1247, 1281 (same).

184. See *supra* note 50 and accompanying text (discussing distinction between discretionary and nondiscretionary account).

lack of authority exists that the broker would have a duty to disclose. Conversely, in situations involving unauthorized trading in nondiscretionary accounts, the broker has a duty to disclose a lack of authority¹⁸⁵ and, therefore, unauthorized trading in nondiscretionary accounts is deceptive.¹⁸⁶

The purchase-or-sale requirement and the fraud, manipulation, or deception requirement of Rule 10b-5 create the primary barriers to the applicability of Rule 10b-5 to broker conversions of customer property.¹⁸⁷ The practical concerns articulated in the Supreme Court's decisions in *Blue Chip Stamps* and *Santa Fe*, however, provide general policy-oriented restrictions upon the scope of Rule 10b-5.¹⁸⁸ Allowing Rule 10b-5 claims for broker conversions of customer property would have no serious practical consequences.¹⁸⁹ The federal courts can determine damages in broker conversion cases with reasonable certainty.¹⁹⁰ Customers would receive the value of converted securities or the amounts needed to restore customer accounts to reflect only authorized trading.¹⁹¹ In situations involving a broker pledge of customer securities, the customer should receive the amount of any losses directly related to the broker's impairment of the customer's security interest.¹⁹² Moreover, in broker conversion situations, a Rule 10b-5 plaintiff's case rests on objectively verifiable facts.¹⁹³ The plaintiff's allegation of broker conversion involves specific transactions. Thefts, pledges, and unauthorized trades are discrete events. A customer, therefore, would not base

185. See *supra* note 59 and accompanying text (discussing broker's duty to disclose lack of authority when broker converts customer property).

186. See *supra* notes 58-59 and accompanying text (discussing conflicting federal court decisions concerning deception involved in unauthorized trading in nondiscretionary accounts).

187. See *supra* note 17 and accompanying text (discussing status of purchase-or-sale requirement and fraud, manipulation, or deception requirement as primary barriers to application of Rule 10b-5 to broker conversions of customer property).

188. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (practical problems involved in recognition of breach of fiduciary duty as within scope of Rule 10b-5 demand that no Rule 10b-5 claim can exist absent fraud, manipulation, or deception); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735-55 (1975) (practical problems inherent in recognition of standing under Rule 10b-5 for nonpurchasers and nonsellers of securities demand denial of standing under Rule 10b-5 to nonpurchasers and nonsellers).

189. See *infra* notes 190-97 and accompanying text (discussing lack of practical problems involved in application of Rule 10b-5 to broker conversion of customer property).

190. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734-35 (1975) (conjectural or speculative recovery is undesirable in Rule 10b-5 actions); *supra* note 26 and accompanying text (noting that determination of damages was concern of Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*).

191. See *JACOBS, supra* note 4, at § 260.03[c][vii][R] (remedy to Rule 10b-5 plaintiff for claim involving defendant's unauthorized use of property is money damages sufficient to place customer in position that customer would have occupied had defendant not acted without authority).

192. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1021 (6th Cir. 1979) (noting plaintiff's damages relating to broker's pledge of customer's securities).

193. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-46 (1975) (noting that Rule 10b-5 violations resting upon speculative and unverifiable fact allegations are improper).

his Rule 10b-5 claim upon speculative allegations of the customer's action if the broker had not engaged in wrongdoing.¹⁹⁴ Furthermore, the potential class of plaintiffs who might allege broker conversions is not limitless because a plaintiff would not have a Rule 10b-5 claim unless the plaintiff could allege specific acts of conversion affecting the plaintiff's property.¹⁹⁵ Finally, the application of Rule 10b-5 to broker conversions of customer property would not unduly supplant state law.¹⁹⁶ Regulation of securities brokers is largely the concern of federal legislation, not of state tort law.¹⁹⁷ The application of Rule 10b-5 to broker conversions of customer property thus does not create practical problems that would justify the exclusion of broker conversion claims from the scope of Rule 10b-5.

The final and most basic question in determining the scope of Rule 10b-5 is whether the application of Rule 10b-5 to broker conversions of customer property serves the purposes of Rule 10b-5.¹⁹⁸ Although the application of Rule 10b-5 to broker conversions requires a liberal interpretation of the language of Rule 10b-5, the federal courts have stated consistently that a flexible application of Rule 10b-5 is proper when the application serves the purposes of Rule 10b-5.¹⁹⁹ One purpose of the federal securities laws is to foster honesty and fair dealing in every facet of the securities industry.²⁰⁰ Due to a broker's position of trust and importance in upholding the integrity of securities markets, a broker must meet an exceptionally high ethical standard in performing his duties.²⁰¹ One of the purposes of Rule 10b-5 is to enforce high ethical standards upon brokers.²⁰² Broker

194. See *id.* at 734 (plaintiff's allegation that plaintiff would have purchased securities absent defendant's wrongdoing is improper basis for Rule 10b-5 claim).

195. See *id.* at 747-48 (stating that Rule 10b-5 should not apply to situations that potentially might involve limitless class of plaintiffs).

196. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478-79 (1977) (Rule 10b-5 claim that unduly would supplant state corporate law is improper).

197. See N. WOLFSON, R. PHILLIPS & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* ¶ 1.01 (1985) (federal law dominates regulation of brokers; state law is merely supplementary to pervasive scheme of federal regulation); Jacobs, *supra* note 3, at 872 (same).

198. See JACOBS, *supra* note 4, at § 6 (Rule 10b-5 should apply to only those situations when Rule 10b-5 applicability serves purposes underlying Rule 10b-5).

199. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (Rule 10b-5 is "catchall" fraud provision and is liberally construed); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977) (Rule 10b-5 should be construed liberally, not technically and restrictively); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (provisions of Securities Exchange Act should be broadly construed to effectuate remedial purposes). See generally JACOBS, *supra* note 4, at § 7 (discussing interpretation of Rule 10b-5).

200. See *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (federal securities laws are intended to foster honesty and fair dealing in all facets of securities industry).

201. See *supra* note 56 and accompanying text (discussing exceptionally high standards of conduct applying to brokers under Rule 10b-5).

202. See, e.g., *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983) (one purpose of Rule 10b-5 is to foster high standards of business ethics in securities industry); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981) (same); *Carothers v. Rice*, 633 F.2d 7, 14 (6th Cir. 1980) (same). See generally JACOBS, *supra* note 4, at § 6.06 (discussing promotion of high ethical standards in securities industry as purpose of Rule 10b-5).

conversions of customer property are inherently dishonest, unfair, and unethical practices.²⁰³ The application of Rule 10b-5 to broker conversions of customer property, therefore, advances the objectives of Rule 10b-5 by promoting broker honesty, integrity, and fair dealing with customers.

The law concerning the applicability of Rule 10b-5 to broker conversions of customer property is conflicting and inconsistent.²⁰⁴ The uniform application of Rule 10b-5 to a wide variety of broker conversions of customer property is the proper resolution to the current conflict among the federal courts. Distinguishing between various acts of conversion by brokers in determining Rule 10b-5 applicability is improper because unauthorized broker trading, unauthorized broker pledges, and broker thefts of customer securities are substantially similar acts.²⁰⁵ A liberal construction of Rule 10b-5 allows broker conversions to satisfy the purchase-or-sale requirement and the fraud, manipulation, or deception requirement of Rule 10b-5.²⁰⁶ Permitting Rule 10b-5 claims based upon allegations of broker conversions of customer property will not create the kind of practical problems in litigation about which the Supreme Court has expressed concern.²⁰⁷ The applicability of Rule 10b-5 to broker conversions will further the objectives of Rule 10b-5 by promoting high ethical standards for brokers.²⁰⁸ Rule 10b-5, thus, should apply to broker pledges, thefts, and misappropriations of customer securities.²⁰⁹ Rule 10b-5 also should apply to broker unauthorized trading in customer nondiscretionary trading accounts.²¹⁰ The application of Rule 10b-5 to broker conversions of customer property will strengthen the status of Rule 10b-5 as the most significant investor protection law ever created.²¹¹

WILLIAM WALTHER SENFT

203. See *supra* notes 175-80 and accompanying text (discussing deceptive, and therefore dishonest and unethical, nature of broker conversions of customer property).

204. See *supra* notes 58-59, 61, 76, & 86-87 and accompanying text (discussing conflicts and inconsistencies in federal court resolutions concerning applicability of Rule 10b-5 to broker conversions).

205. See *supra* notes 145-56 and accompanying text (distinguishing between broker thefts, misappropriations, pledges, or unauthorized trading in determining Rule 10b-5 applicability is improper).

206. See *supra* notes 157-86 and accompanying text (broker conversions constitute fraud and deception in connection with purchase or sale of securities).

207. See *supra* notes 188-97 and accompanying text (discussing practical aspects of litigating broker conversion claims under Rule 10b-5).

208. See *supra* notes 198-203 and accompanying text (applicability of Rule 10b-5 to broker conversions serves purposes of Rule 10b-5).

209. See *supra* notes 141-42 and accompanying text (broker thefts, misappropriations, and pledges of customer securities should be within scope of Rule 10b-5).

210. See *supra* note 143 and accompanying text (Rule 10b-5 should apply to unauthorized broker trading in customers' nondiscretionary trading accounts).

211. See JACOBS, *supra* note 4, at § 1 (Rule 10b-5 is most important securities regulation in United States).