Client ALERT

July 2002

SEC Anti-Fraud Rule 10b-5 Broadly Construed by Supreme Court

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In *SEC v. Zandford*, 535 U.S. ___, 122 S.Ct. 1899 (2002), the United States Supreme Court has once again addressed the basic jurisdictional requirement for a fraud claim under the Securities and Exchange Commission's "catch-all" anti-fraud Rule 10b-5. In finding a stockbroker's unauthorized sale of client securities and conversion of the sale proceeds to be "in connection with the purchase or sale of any security," the Supreme Court has reaffirmed its long-held view that the federal securities laws must be construed flexibly to achieve their remedial purposes. This salutary goal was achieved, however, at the risk of potentially expanding the reach of federal securities law to an area which was arguably outside its scope beforehand. Because *Zandford* does not set forth a clear test to govern future application of the "in connection with" requirement, the decision may also lead to an increased risk of both private litigation and SEC enforcement activity for issuers, traders, brokers and other investment professionals as the lower courts struggle to delineate the precise contours of the law on a case by case basis.

The "In Connection With" Requirement

The main anti-fraud provision found in the federal securities law, Section 10(b) of the Securities Exchange Act of 1934, forbids "any person" from using, "*in connection with the purchase or sale of any security* . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."[1] The SEC's Rule 10b-5 makes it unlawful for "any person . . .to make any untrue statement of a material fact or to omit to state a material fact . . . or . . . to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security*."[2]

Although the phrase "in connection with the purchase or sale of any security" on its face would suggest a straightforward meaning, judges and legal commentators alike have noted that on closer examination the requirement becomes difficult to define or apply to particular facts.[3] While misrepresentations concerning the nature or value of a security made to induce a particular buyer to purchase would clearly be made "in connection with" that purchase, are other statements covered? For example, are statements concerning the financial health of a company sufficiently "connected" to a pledge of unrelated securities by that company to support a 10b-5 claim?[4] What if a purchaser enters into an agreement to purchase securities with the intent to renege if the securities decline in value?[5] What if a business advisor misrepresents her qualifications and experience in order to induce customers to retain her?[6]

In struggling with these and other fact patterns, the federal courts have until recently had little guidance from the Supreme Court. Its last major decision construing the "in connection with" requirement, *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), dealt with a scheme in which an insurance company was manipulated into selling its Treasury bill reserves by the false representation that it would receive the proceeds of the sale, when in fact those proceeds were used by outsiders to purchase 100% of the insurance company's stock. In finding that the insurance company could state a claim under federal law, the Court stated only that section 10(b) "must be read flexibly, not technically and restrictively" and that the insurance company "suffered injury as a result of deceptive practices *touching* its sale of securities as an investor."[7] This admittedly cryptic language spawned two basic lines of precedent: in one, appellate courts read the "touching" language to authorize a broad reading of the "in connection with" requirement, holding the requirement satisfied when the fraudulent conduct and the sale pertained to the same fraudulent scheme,[8] or where the fraud influenced an investment decision.[9] The other, less prevalent line of cases reads no particular meaning into the Supreme Court's "touching" language,[10] and limits the "in connection with" requirement to cases involving misrepresentations concerning the value of the relevant stock or the consideration paid for it.[11]

This uncertainty as to the meaning of the "in connection with" requirement had resulted in inconsistent results in cases involving brokers who disposed

of client securities and stole the resulting cash. The SEC has consistently asserted that such activity violates federal securities law,[12] and some appellate courts have agreed.[13] On the other hand, other courts facing similar broker defalcations have held that, in the absence of affirmative misrepresentations or omissions concerning the character of the securities involved, such acts are more properly governed by the state common law of fraud, breach of fiduciary duty, and conversion, not federal securities law.[14]

The Supreme Court's *Zandford* Decision

In *SEC v. Zandford*, 535 U.S. ___, 122 S.Ct. 1899 (2002), the Supreme Court was forced to confront the nature and purpose of the "in connection with" requirement in the context of broker defalcation. In 1987, Zandford, a broker, persuaded William Wood, an infirm, elderly man, to open a discretionary trading account for himself and his developmentally disabled daughter. Zandford promised to invest their funds "conservatively," and based on this Wood entrusted him with over $400,000.00. In fact, Zandford sold the securities he was supposed to be managing and pocketed the proceeds, at times by writing checks against a mutual fund account which could only be honored by selling fund shares. By the time Zandford's activities were discovered in 1991, all of Wood's assets were gone.

Zandford was criminally indicted for wire fraud in the U.S. District Court for the District of Maryland, and was also the subject of an SEC civil action alleging that he violated Rule 10b-5. After Zandford was convicted and sentenced to prison, the SEC moved for partial summary judgment in the civil suit, stating that Zandford's conviction should prevent him from contesting his 10b-5 liability. The district court granted this motion, but was reversed by the U.S. Court of Appeals for the Fourth Circuit, which remanded and ordered that the SEC's complaint be dismissed. In its decision[15] the Fourth Circuit found that Zandford's conviction for wire fraud did not foreclose him from contesting the 10b-5 claim, and that the SEC had in fact failed to state a 10b-5 claim as a matter of law. In so ruling the court noted that Zandford made no statements or omissions concerning a particular security, or to induce a particular sale.[16] As such, his acts constituted nothing more than a breach of his fiduciary duty to Wood which, though reprehensible, did not warrant expanding the scope of federal securities law.[17] In particular, the Fourth Circuit cited prior Supreme Court decisions emphasizing that Congress did not intend to create a federal cause of action for general breaches of fiduciary duty when it enacted section 10(b).[18]

The Supreme Court reversed the Fourth Circuit's decision. While noting that 10(b) "must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b)," the Supreme Court nevertheless noted that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act."[19] Zandford's view was that the alleged scheme was not materially different from a simple theft of cash or securities in an investment account with no connection to a sale of securities. The Court disagreed and found that "each sale was made to further respondent's fraudulent scheme; each was deceptive because it was neither authorized by, nor disclosed to, the Woods."[20] The Court analogized this scheme to the securities law claim it upheld in the *Bankers Life* case, and noted that in its recent *Wharf* and *O'Hagan* decisions it had found claims involving the sale of an option with the secret intent not to honor it, as well as an attorney's misappropriation and use of inside information concerning a counterparty to a merger, to meet the "in connection with" requirement.[21] The Court concluded that "[a]s in *Bankers Life*, *Wharf*, and *O'Hagan*, the SEC complaint describes a fraudulent scheme in which the securities transactions and breaches of fiduciary duty coincide," and therefore found that Zandford's breaches met the "in connection with" requirement.[22] The Court ended its opinion by asserting that its analysis would not transform every breach of fiduciary duty into a federal claim because activities such as embezzlement of cash would have no connection to a purchase or sale of securities.[23]

The Impact of *SEC v. Zandford*

It is difficult to quibble with the result reached in *SEC v. Zandford*: Zandford's actions were truly unconscionable, and allowing brokers like him to operate unchecked would clearly tend to undermine public trust in the securities markets, something the federal securities laws were designed to prevent. In addition, prior decisions exempting broker conversion from 10b-5 coverage may no longer be good law, and the Supreme Court seems to be endorsing a broad reading of the "in connection with" requirement, thereby casting doubt on the continued vitality of the line of cases espousing a narrower view.

However, the Supreme Court did not set forth a clear test to guide lower courts in future cases. From its emphasis on the fact that Zandford's fraud "coincided" with his sales of securities, the Supreme Court might be indicating its approval of the line of cases holding that the sales and the fraud need only pertain to the same "fraudulent scheme"; unfortunately, the Supreme Court did not explicitly

refer to any of this prior authority in its opinion. In addition, despite the Court's disclaimer of any such intent, it is far from clear that the Court's rationale does not create a federal cause of action for breaches of fiduciary duty previously regulated only by state law.

Going forward, the federal courts will continue to struggle with the precise contours of the "in connection with" requirement on a case by case basis. It is also likely that the SEC, having had its long-held view concerning broker conversion definitively vindicated, will "press the envelope" in future enforcement activity, using *Zandford* in an attempt to expand Rule 10b-5's reach to cover newer forms of fraudulent conduct involving securities. There are, however, some potential procedural benefits to a broader "in connection with" requirement. For example, the Securities Litigation Uniform Standards Act of 1998 prohibits class actions brought under state law for fraud "in connection with" certain "covered securities," and allows defendants to remove such actions from state to federal court, where they are subject to automatic dismissal.[24] Plaintiffs seeking to avoid this result had occasionally succeeded in arguing that their claims did not allege fraud "in connection with" a "covered security" under a narrow reading of the requirement.[25] In light of *Zandford*, this argument is much less likely to succeed in the future.

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1 15 U.S.C. § 78j (emphasis supplied).

2 17 C.F.R. 240.10b-5.

3 *See, e.g.*, Lewis D. Lowenfels and Alan R. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 Bus. Law 1 (November, 2001) ("The precise meaning of the words '[fraud] in connection with the purchase or sale of any security' . . . has never been completely clear."); *Chemical Bank v. Arthur Andersen*, 726 F.2d 930, 942 (2d Cir. 1984) (quoting leading treatise for proposition that "the 'in connection with' phrase 'is not the least difficult aspect of the 10b-5 complex to tie down.'")

4 *See Chemical Bank v. Arthur Andersen*, 726 F.2d 930 (2d Cir. 1984) (accounting firm's misrepresentations concerning parent's financials were not "in connection with" the purchase and sale of a security, where loan transaction at issue involved pledge of subsidiary's stock, not parent's).

5 *See A.T. Brod v. Perlow*, 375 F.2d 393 (2d Cir. 1967) (purchaser's fraudulent failure to pay for securities would, if proven at trial, state a claim for securities fraud).

6 *See Abrash v. Fox*, 805 F. Supp. 206 (S.D.N.Y. 1992) (attorney's misrepresentations concerning his qualifications and intent to act as plaintiffs' business advisor in formation of corporation did not relate to nature of securities plaintiffs purchased in corporation, so that no claim for federal securities fraud existed).

7 *Id.* at 13-14 (emphasis supplied).

8 *E.g., Alley v. Miramon*, 614 F.2d 1372, 1378 (5th Cir. 1980).

9 *E.g., Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537 (2d Cir. 1999); *SEC v. Jakubowski*, 150 F.3d 675, 680 (7th Cir. 1998).

10 *E.g., Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir. 1984) (citing Professor Louis Loss for view that "there is no reason to believe that the Justice's use of 'touching' was anything more than his variation of 'in connection with' as a matter of literary style").

11 *Id.* at 943 ("The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions – to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be."); see also *Hunt v. Robinson*, 852 F.2d 786, 787 (4th Cir. 1988). There are also some decisions which appear to stake out a middle ground on the issue, holding that a misrepresentation must be "integral" to a purchase or sale of securities to satisfy the statute. See *Pross v. Katz*, 784 F.2d 455 (2d Cir. 1986).

12 Brief for Petitioner at 12, *SEC v. Zandford*, 535 U.S. ___, 122 S.Ct. 1899 (2002).

13 *E.g., United States v. Kendrick*, 692 F.2d 1262 (9th Cir. 1982).

14 *See Bochicchio v. Smith Barney, Harris Upham & Co.*, 647 F. Supp. 1426 (S.D.N.Y. 1986) (broker's unauthorized sales and conversion of proceeds did not give rise to federal securities law claim); see also, *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595 (2d Cir. 1991) (clearing agent's failure to deliver stock, and broker's

preparation of customer statement incorrectly reflecting delivery of stock, were not acts "in connection with" a purchase or sale where, by necessity, acts occurred after customer placed order for purchase).

15 *SEC v. Zandford*, 238 F.3d 559 (4th Cir. 2001), rev'd 535 U.S. ___, 122 S.Ct. 1899 (2002).

16 *Id.* at 564, 566.

17 *Id.* at 566.

18 *Id.* (citing *United States v. O'Hagan*, 521 U.S. 642 (1997)).

19 *SEC v. Zandford*, 535 U.S. ___, 122 S.Ct. 1899, 1903 (2002).

20 *Id.* at 1904 ("This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. Nor is it a case in which a thief simply invested the proceeds of a routine conversion in the stock market. Rather, respondent's fraud coincided with the sales themselves.")

21 *See Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.* 532 U.S. 588 (2001) (sale of option made with intent not to honor it governed by 10b-5); *United States v. O'Hagan*, 521 U.S. 642 (1997) (finding attorney's misappropriation and trades using inside information concerning counterparty to merger transaction violated 10b-5).

22 *SEC v. Zandford*, 535 U.S. ___, 122 S.Ct. 1899, 1906 (2002).

23 *Id.* at 1906, n.4.

24 15 U.S.C. §§ 78bb(f)(1), 78bb(f)(2).

25 *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 01 Civ. 3013 (DLC), 2001 WL 1182927 (S.D.N.Y. October 9, 2001) (misrepresentations concerning transaction fee were not sufficiently connected to value of security to support 10b-5 liability).