08-6166-cv (L)

08-6167-cv(CON)
08-6230-cv(CON)

In the
United States Court of Appeals
For the Second Circuit

CAPITAL MANAGEMENT SELECT FUND LTD., INVESTMENT & DEVELOPMENT FINANCE CORPORATION, IDC FINANCIAL S.A., GLOBAL MANAGEMENT WORLDWIDE LIMITED, INDIVIDUALLY and on behalf of all others similarly situated, ARBAT EQUITY ARBITRAGE FUND LIMITED, RUSSIAN INVESTORS SECURITIES LIMITED, VR GLOBAL PARTNERS, L.P., PATON HOLDINGS, LTD., VR CAPITAL GROUP LTD., and VR ARGENTINA RECOVERY FUND LTD.,

Plaintiffs-Appellants,

– v. –

PHILLIP R. BENNETT, WILLIAM M. SEXTON, PHILIP SILVERMAN, ROBERT C. TROSTEN, RICHARD N. OUTRIDGE, THOMAS H. LEE PARTNERS, LP,

Defendants-Appellees,

(For Continuation of Caption See Inside Front Cover)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON ISSUES ADDRESSED

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Defendants-Appellees,

———————————————————————————————————

JOSEPH J. MURPHY, RONALD O'KELLEY, NATHAN GANTCHER, DENNIS A. KLEJNA, PERRY ROTKOWITZ, CREDIT SUISSE GROUP, CREDIT SUISSE FIRST BOSTON, GOLDMAN SACHS GROUP, INC., GOLDMAN SACHS & CO., BANK OF AMERICA SECURITIES, LLC, BANK OF AMERICA CORP, MERRILL LYNCH & CO, MERRILL LYNCH PIERCE, FENNER & SMITH INCORPORATE, JP MORGAN CHASE & CO, JP MORGAN SECURITIES, INC., SANDLER O'NEIL & PARTNERS, L.P., HSBC HOLDINGS, PLC, HSBC SECURITIES {USA} INC., WILLIAM BLAIR & COMPANY, LLC, HARRIS NESBITT CORP., CMG INSTITUTIONAL TRADING, LLC, SAMUEL A.. RAMIREZ & CO., INC., THE WILLIAMS CAPITAL GROUP, L.P., UTENDAHL CAPITAL PARTNERS, L.P., REFCO SECURITIES, LLC, THL ENTITIES,

Defendants,

BANK FUR ARBEIT UND WIRTSCHAFT UND OSTERRECIHISCHE POSTPARKASSE AKTIENGESELLSEHAFT,

Consolidated-Defendant.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND SUMMARY OF ITS POSITION

The Securities and Exchange Commission, the agency principally responsible for the enforcement and administration of the federal securities laws, submits this brief as *amicus curiae* pursuant to Fed. R. App. P. 29(a) to address important securities law issues presented in these appeals.

First, we address the question whether a brokerage firm customer has standing as a seller under *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("*Blue Chip*"), to bring a private damages action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, when the brokerage firm violated these provisions by selling the customer's securities without authorization and converting the proceeds to its own use. The district court here held that a customer lacks standing to bring a private damages action when he alleges he is a victim of such a violation, reasoning that, even though his securities have been sold, he is not a seller because the firm took the proceeds of the unauthorized sales for its own use rather than placing them in the customer's account–the latter violation being one as to which the district court recognized the customer *would* have standing. This holding, if upheld on appeal, would mean that customers who are the victims of the serious type of fraud the Supreme Court recognized in *SEC v. Zandford*, 535 U.S. 813 (2002), as a violation

of Section 10(b)–the unauthorized sale of customers' securities by a broker in order to convert the proceeds–could not bring private damages actions for such fraud.

The Commission believes that, contrary to the view of the district court, the fact that the brokerage firm is alleged to have converted the proceeds of the unauthorized transactions, rather than placing the proceeds in the customer's account, should not deprive the customer of standing to bring a private action. Although the district court's holding regarding standing does not affect the Commission's ability to bring enforcement actions for the conduct alleged here, private actions are an "essential supplement" to Commission enforcement actions. *See, e.g.*, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). Further, there is nothing in the *Blue Chip* decision to support the distinction made by the district court here: recognizing standing when the plaintiff/customer alleges that the proceeds of unauthorized transactions were placed in the customer's account but denying standing when he alleges that the brokerage firm misappropriated the proceeds of unauthorized transactions to its own use.

Second, the Commission believes the district court erred in its interpretation of the scope of Section 10(b) and Rule 10b-5. The district court suggested that this Court's recent decision in *United States v. Finnerty*, 533 F.3d 143 (2d Cir.

2008), required, in order to allege deceptive representations within the meaning of the statute and rule, allegations of *express* misrepresentations. The logical result of the district court's interpretation would be to abolish the 70-year-old shingle theory–a doctrine grounded in common law fraud–under which a broker-dealer engages in deception not only when it makes *express* misrepresentations, but also when it engages in conduct inconsistent with the shingle theory's *implied* representation of fair dealing in accordance with standards of the profession – such as secretly selling its customer's securities in order to convert the proceeds to its own use. Restricting Section 10(b)'s "catch-all" antifraud provision (*e.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983)) to encompass only express misrepresentations and not to proscribe implied misrepresentations would prevent both the Commission and private plaintiffs from bringing actions for well-recognized forms of fraud by broker-dealers, long held to be covered by the statute.

The Commission also believes that, contrary to the district court's apparent view, even if a customer had an outstanding margin loan at the time the broker hypothecated the customer's securities, under the shingle theory the broker acts deceptively if it accepts repayment of the margin loan without disclosing its inability to redeem the customer's securities from hypothecation (and resulting

inability to deliver the fully paid securities to the customer). The district court's treatment of this issue, and the broader implied misrepresentation issue, are at odds with the shingle theory.

The Commission accordingly urges that the Court adopt the interpretations expressed in this brief.

ISSUES ADDRESSED BY THE COMMISSION

1. Whether a brokerage firm customer has standing as a seller to bring a private action for damages under Rule 10b-5 when the firm, in violation of the rule, defrauds the customer by selling the customer's securities and converting the proceeds to the firm's own use.

2. Whether Rule 10b-5 proscribes not only express misrepresentations but also implied misrepresentations, including, as the Commission has long held, the shingle theory's implied representation–made by a broker-dealer when it does business with a customer–that it will treat the customer fairly, in accordance with standards of the profession.

3. Whether under the shingle theory a brokerage firm acts deceptively when it accepts the customer's repayment of a margin loan without disclosing to the customer its inability to redeem (or intent not to redeem) the customer's securities from hypothecation or repurchase agreements, so that the customer's securities

will not be returned to him even though he has repaid the margin loan. 1/

STATEMENT OF RELEVANT FACTS

These appeals were taken in three consolidated private actions arising from the alleged sale by broker-dealer Refco Capital Markets, Ltd. ("RCM"), for its own benefit, of the customer/plaintiffs' securities in their accounts at RCM. RCM was a subsidiary of Refco Group, Ltd. and Refco, Inc. (collectively, "Refco"). *In re Refco Capital Markets, Ltd. Brokerage Customer Securities Litigation*, 586 F. Supp. 2d 172, 175 (S.D.N.Y. 2008). The plaintiffs allege that the defendants (various officers and control persons of RCM) caused RCM to sell plaintiffs' securities without authorization for RCM's own benefit by using the proceeds of the sales to finance Refco's daily operations, trading losses and significant acquisitions. *Id*. at 179. 2/ The complaints allege that RCM, through the

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1/ This brief does not address other issues presented in these appeals. This should not be interpreted as indicating that the Commission does or does not agree with either the district court or any party on those issues.

2/ The complaints all allege that RCM operated as a securities brokerage firm in the United States. Although RCM had an address in Bermuda, the complaints allege that it had no employees there and conducted all its business in the United States through employees of Refco Securities, LLC, another Refco subsidiary that was a U.S. broker-dealer registered with the Commission. The district court, consistent with these allegations, decided the case on the premise that RCM was subject to the panoply of U.S. securities regulation. We base our arguments on the same premise as did the district court in order to reach legal issues addressed by that court.

defendants, violated Section 10(b) by selling for RCM's benefit the plaintiffs' fully paid and excess margin securities which the plaintiffs had entrusted to RCM in their nondiscretionary accounts at the firm. 3/ The sales consisted of hypothecations 4/ and repurchase agreements.

The plaintiffs are all former customers of RCM who had nondiscretionary margin accounts at RCM (*see* 586 F. Supp. 2d at 175), allegedly opened in response to solicitations the plaintiffs received from RCM (*see* VR Compl. ¶ 84), and who placed securities with or held securities at RCM and/or its sister company, Refco Securities, LLC ("RSL") 5/ at any time from October 17, 2000, to October 17, 2005 (586 F. Supp. 2d at 175). RCM was a subsidiary of Refco, which was a provider of brokerage and clearing services. *See In re Refco, Inc. Securities Litigation*, 503 F. Supp. 2d 611, 618-19 (S.D.N.Y. 2007); *In re Refco Capital Markets, Ltd. Brokerage Customer Securities Litigation*, 2007 WL

3/ Under Exchange Act Rule 15c3-3(a)(5), 17 C.F.R. 240.15c3-3(a)(5), excess margin securities are securities carried in a customer's margin account or accounts having a value in excess of 140% of the amount of the broker-dealer's margin loan to the customer.

4/ A pledge of a security is a "sale" under the securities laws' antifraud provisions. *See infra* at 15.

5/ *See* n.2 *supra*.

2694469 at *4 (S.D.N.Y. Sept. 13, 2007) ("*RCM I*"). 6/ In the late 1990's, Refco made risky loans that became millions of dollars in "uncollectible receivables" that would never be repaid. *RCM I* at *4. To hide the fact that these assets had become worthless, Refco management devised a "round-robin" scheme in which the uncollectible receivables were transferred onto the books of Refco Group Holdings, Inc. ("RGHI"), another Refco affiliate. *Id*. Then, another Refco subsidiary (apparently, RCM) would lend money to a third party, which would in turn lend it to RGHI to pay down the uncollectible receivables, erasing them from Refco's books. *Id*. at *4 & n.4.

Refco Inc. made an initial public offering on August 11, 2005, and nine weeks later, on October 10, 2005, announced it had discovered the circular transactions referred to above and "disavowed its financial statements for the years 2002, 2003, and 2004." *Id*. at *4. After this disclosure, customers of RCM began attempting to withdraw their assets from their margin accounts at RCM, and Refco imposed a moratorium on withdrawals from RCM. *Id*. The plaintiffs here allege that they had no margin loans outstanding in October 2005, and sought to withdraw their securities from their RCM accounts at that time, but that RCM was

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6/ In *RCM I*, 2007 WL 2694469, the district court dismissed the first class action complaint on the ground that it failed to allege the required deception for a Section 10(b) claim. *See* 586 F. Supp. 2d at 174.

unable to deliver the securities because it had sold the securities in hypothecations and repo transactions, and was financially unable to redeem the securities from the hypothecation or repo transactions. On October 17, 2005, Refco and some subsidiaries, including RCM, filed for bankruptcy; Refco has acknowledged in the bankruptcy proceedings that RCM owes its customers $4.16 billion but has only $1.9 billion in assets. *Id.* A substantial part of the difference represents debt owed to RCM by other Refco affiliates. *Id.*

THE DISTRICT COURT DECISION

The decision at issue here, 586 F. Supp. 2d 172, dismissed the Second Amended Class Complaint ("Class Complaint") and two other complaints based on similar allegations, on the grounds that: (1) the plaintiffs lacked standing as sellers because RCM sold their securities for its own benefit rather than for theirs and (2) all three complaints failed sufficiently to allege deception. The dismissal was with prejudice and the district court later, in its decision on reconsideration (2008 WL 4962985 (S.D.N.Y. Nov. 20, 2008)), denied the plaintiffs' reconsideration motion seeking leave to replead.

As to standing, the district court distinguished the allegations of the complaints at issue here from situations in which, the district court acknowledged, the customer *would* have standing as a purchaser or seller despite the fact that he

did not voluntarily enter into the transactions–such as mere unauthorized trading cases and churning cases, which "involve transactions undertaken by the broker for the customer's account." 586 F. Supp. 2d at 179. "In contrast," the district court reasoned, the complaints here "specifically allege that RCM sold plaintiffs' securities without authorization *for RCM's own benefit* by 'us[ing] the proceeds to finance Refco's daily operations, trading losses and significant acquisitions.'" *Id*. (emphasis in original), quoting Class Compl. ¶ 5; VR Compl. ¶ 5; Capital Compl. ¶ 4 (alteration in court's decision). "Such allegations simply do not demonstrate that plaintiffs themselves were 'actual . . . sellers of securities' under [*Blue Chip*]." 586 F. Supp. 2d at 179.

Thus, the district court held that: (1) a customer would have standing as a seller under *Blue Chip* if a broker-dealer sells the customer's securities without authorization and puts the proceeds in the customer's account (as would be the case in churning and unauthorized trading situations); but (2) the same customer would not be a seller, and standing would be denied, if the broker-dealer commits a more serious fraud by selling the customer's securities without authorization and misappropriating the proceeds of the sales–in other words, selling the securities "for the broker's own benefit" (586 F. Supp. 2d at 180), as occurred in *Zandford*.

The district court also dismissed the complaints on the alternative ground

that they failed to allege deception as required under Section 10(b) and Rule 10b-5. According to the district court (586 F. Supp. 2d at 181), "the basis for plaintiffs' Rule 10b-5 claims . . . is deceptive conduct, rather than market manipulation," based "solely on RCM's alleged unauthorized sale of their securities." *Id.* The district court concluded that the complaints failed to allege deception because, the court determined, the plaintiffs failed to allege "the source of the understanding falsely created by defendants (that is, a fiduciary duty, prior representation, or some other reason why they believed defendants would act otherwise than they did)." *Id.*

The district court rejected the plaintiffs' contention that the customer agreement (which the court characterized as a "standard-form" customer agreement) led customers to expect that their fully paid and excess margin securities would be held by RCM as custodian for their benefit, and not be re-hypothecated by RCM – *i.e.*, led customers to expect that RCM could use or re-hypothecate a customer's securities only up to the amount of the customer's outstanding margin loans. 586 F. Supp. 2d at 181. The district court read the customer agreement's section on margin transactions to provide that RCM could hypothecate or otherwise use or dispose of *all* of a customer's securities, rather than only securities needed as collateral against a margin balance, if the customer

had *any* outstanding margin loan. *Id*. at 184. Thus, the court concluded, the plaintiffs could not have been deceived by RCM's disposition or sale of their fully paid or excess margin securities – even millions of dollars of such securities – when the plaintiffs had any margin loan outstanding, however small. *Id*.

The district court also rejected (*id*. at 184-85) the plaintiffs' contention that they adequately alleged deception by alleging that RCM was secretly using their securities in October 2005 when the plaintiffs had no margin debt. Specifically, the plaintiffs had alleged that, although they had no margin debt in October 2005 when they demanded delivery of their securities, RCM at that time was unable to deliver the fully paid securities because the firm was still, without disclosure, using the securities in hypothecations and repo transactions from which RCM was unable to redeem the securities due to RCM's insolvency. Although the district court interpreted the customer agreement as not allowing RCM to hypothecate or otherwise dispose of a customer's securities when the customer had no outstanding margin loan, the district court reasoned that the allegation regarding the lack of margin loans in October 2005 was not significant because it was possible the plaintiffs might have had margin loans at the time RCM entered into the transactions using the plaintiffs' securities; according to the district court, the fact that the plaintiffs later paid off the margin loans but RCM kept the securities

was not inconsistent with its reading of the customer agreement. *Id*. at 185. The district court viewed RCM's use of a customer's securities in a hypothecation or repurchase agreement as a one-time event which, if entered into at a time when the customer had an outstanding margin loan, was consistent with the customer agreement here and not deceptive, even if the customer later paid off the margin loan. *Id*. According to the district court, the fact that the plaintiffs paid off the margin loans but RCM failed to redeem the plaintiffs' securities from hypothecation "may be a breach of [RCM's] contractual obligation" to return the securities to the plaintiffs, but it was not "*deceptive*" (emphasis in original) because plaintiffs failed to allege specific dates when RCM entered into transactions using plaintiffs' securities at times when they had no margin loans. *Id*.

In addition, the district court rejected the plaintiffs' argument that the defendants deceived them by not disclosing that RCM was violating Commission customer protection rules and was "not properly protecting customer assets." 586 F. Supp. 2d at 191. The district court believed, based on *Finnerty*, that that argument was "squarely foreclose[d]" (*id*.) unless the plaintiffs alleged an "*affirmative misrepresentation or act* that gave plaintiffs a false understanding concerning RCM's use of their assets" (*id*. at 192 (emphasis added)). In *Finnerty*,

this Court held that an NYSE specialist could not be criminally convicted for fraud under Section 10(b) based on his violations of an NYSE rule because he had never affirmatively represented that he would comply with the rule. 533 F.3d at 149-150. The *Finnerty* decision mentioned that the lower court in that case, in a pre-trial ruling, had prohibited the government from arguing the shingle theory as a source of an *implied* representation by the specialist that he would treat customers fairly. *Id*. The district court in the instant case relied on this Court's holding in *Finnerty* without noting that the shingle theory had been excluded from the case and therefore was not before this Court. Thus, the opinion here can be read to suggest that *Finnerty* abolished or restricted the shingle theory and that a broker-dealer therefore cannot be found to have acted deceptively unless he made an express affirmative representation that he would comply with industry standards and/or Commission rules.

ARGUMENT

Because the district court dismissed the complaints for failure to state a claim, the allegations in the complaints are assumed to be true. *See Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007); *Zandford*, 535 U.S. at 818.

I. A CUSTOMER HAS STANDING UNDER SECTION 10(b) AS A SELLER OF SECURITIES WHEN A BROKER-DEALER FRAUDULENTLY SELLS THE CUSTOMER'S SECURITIES WITHOUT AUTHORIZATION, REGARDLESS OF WHAT USE THE BROKER-DEALER MAKES OF THE PROCEEDS OF THE SECURITIES SALES.

The district court's ruling that the plaintiffs were not sellers of securities and lacked standing under *Blue Chip* to bring a Section 10(b) action–even though it was the plaintiffs' securities that the defendants allegedly sold without authorization–is not supported by prior case law or by *Blue Chip*. Although the standing issue does not affect Commission enforcement actions, we believe the district court's holding is a significant and unwarranted restriction on the right to bring private Section 10(b) actions for serious fraudulent conduct–the same type of conduct held in *Zandford* to violate Section 10(b). 7/

In *Blue Chip*, the Supreme Court held that in order to have standing to bring a private damages action under Section 10(b) a plaintiff must be a purchaser or seller of securities. *See* 421 U.S. at 737-49. The Court determined for policy

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7/ We note that although the Supreme Court's decision in *Zandford* had no occasion to address standing to bring a private action, since it was a Commission enforcement action, at the *Zandford* oral argument the Court asked whether the customers could have brought a private action under Section 10(b) on the facts of the case. Counsel representing the Commission in the Supreme Court, an Assistant to the Solicitor General, responded affirmatively, noting that since the customers' securities were sold, the customers would have standing as sellers to bring the action. 2002 WL 485040 at *4 (transcript of oral argument).

reasons that extending standing to those who did not engage in purchases or sales, but because of defendants' fraud were induced *not* to purchase or sell, would improperly subject defendants to burdensome discovery in "strike" suits. *Blue Chip* itself acknowledged that the terms "purchase" and "sale" under the securities laws are defined broadly and include contracts to buy or sell or to "otherwise dispose of" any interest in a security. Subsequent to *Blue Chip*, the courts have recognized that a sale includes a pledge of securities (*see Rubin v. United States*, 449 U.S. 424, 429-31 (1981)) and a "forced sale," as when a shareholder must involuntarily accept an exchange of his securities in a merger (*see Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967)).

The district court here distinguished situations in which, it acknowledged, the customer would have standing as a purchaser or seller–such as unauthorized trading and churning cases, which "involve transactions undertaken by the broker for the customer's account." 586 F. Supp. 2d at 179. "In contrast" to unauthorized trading and churning cases, the district court reasoned, the complaints here "specifically allege that RCM sold plaintiffs' securities without authorization *for RCM's own benefit*." *Id*. (emphasis in original). The district court concluded that a private plaintiff has standing based on unauthorized trades only if the broker puts the securities, or proceeds from the sales thereof, into the customer's account (in

the court's view making the transactions "on [the customer's] behalf"), but not if, as alleged in this case, the broker sells the customer's securities in order to misappropriate the proceeds "for the broker's own benefit" (586 F. Supp. 2d at 180).

The Commission disagrees with the district court's distinction. So long as the securities sold were the customer's securities, or the customer was dispossessed of his securities by the sale, the customer should be viewed as a seller irrespective of where the proceeds are placed. Our position is consistent with the position of the Ninth Circuit, which has held that "when a broker makes an unauthorized purchase or sale of securities *with his customer's assets*, that purchase or sale may be attributed to the customer for purposes of satisfying the [purchaser-seller] rule." *SIPC v. Vigman*, 803 F.2d 1513, 1519 (9th Cir. 1986) (emphasis added); *id*. at 1520 ("[w]e hold . . . that a broker's unauthorized purchase or sale of securities *using a customer's assets* may be attributed to the customer, . . . satisfying the purchase-or-sale requirement" for a private damages action under Section 10(b) and Rule 10b-5) (emphasis added). *Vigman* did not involve a situation in which a brokerage firm made unauthorized transactions and placed the securities or proceeds in the customers' accounts (a situation in which the district court here acknowledged the customers would have standing), since the *Vigman* court noted that the firms were

"supposed to be holding" securities for customers but the securities were "missing" from the customers' accounts (803 F.2d at 1519, 1520). 8/ Moreover, allowing standing to the customer in the misappropriation situation implicates none of the concerns expressed by the Court in *Blue Chip* (*see* 421 U.S. at 737-49); specific transactions will have occurred and there will be no need to rely on a customer's testimony that, but for the fraud, he would have bought or sold securities.

Further, the district court's contrast between unauthorized transactions "for the customer's account" and unauthorized transactions "for [the broker's] own benefit" is a false one. In churning and unauthorized trading cases the broker

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8/ The district court in the present case relied (586 F. Supp. 2d at 179) on *Caiola v. Citibank, N.A.*, 295 F.3d 312 (2d Cir. 2002), but that decision did not make the distinction the district court made here, and we believe *Caiola*'s reasoning does not support the district court's conclusion. In *Caiola*, this Court held that a customer had standing to bring a Rule 10b-5 damages claim when he alleged that without authorization Citibank purchased securities for his account with his funds. The "key fact" that determined the plaintiff had standing in *Caiola* was that, although Citibank contended it made the purchases for its own benefit (to hedge its risk in synthetic transactions with Caiola), the firm "purchased [securities] with Caiola's funds and on his behalf" (the latter phrase in context arguably referring to the fact that the securities were placed in Caiola's account). 295 F.3d at 323-24. *Caiola* does not indicate whether this Court would have ruled differently if Citibank had used Caiola's funds to purchase securities and then *not* placed the securities in Caiola's account (placed them in Citibank's proprietary account or made other use of them)–but the fact that *Caiola* (*id.* at 323) relies in part on *Vigman* may suggest that the *Caiola* court would have held that Caiola had standing even if Citibank had misappropriated the securities rather than placing them in Caiola's account.

carries out the transactions for his own benefit (to earn fees), not for his customer's benefit. Even though the proceeds are returned to the customer's account, the trading is not carried out for the customer's benefit and may dissipate the customer's assets. Similarly, in *Zandford* and in the instant case, the securities sold belonged to the customers, came from the customers' accounts, and were in that sense sold "for the customers' accounts," even though the broker carried out the sales for its own benefit rather than for the benefit of the customers.

In sum, the incongruous distinction the district court made–that a customer has standing as a seller if a broker makes unauthorized sales of the customer's assets and places the proceeds in the customer's account, but lacks standing if the broker commits the worse fraud of selling the customer's assets without authorization and taking the proceeds for his own use, as in *Zandford*–is not supported by the reasoning of *Blue Chip* and has no justification. This Court should reject that interpretation in this case.

II. A BROKER-DEALER ACTS DECEPTIVELY WHEN, WITHOUT DISCLOSURE TO ITS CUSTOMER, IT ACTS INCONSISTENTLY WITH THE IMPLIED REPRESENTATION – MADE BY BROKERAGE FIRMS WHEN THEY DO BUSINESS WITH CUSTOMERS – THAT THE FIRM WILL TREAT CUSTOMERS FAIRLY AND IN ACCORDANCE WITH STANDARDS OF THE PROFESSION.

The complaints allege that RCM acted deceptively when, without disclosure, it sold the plaintiffs' securities for the firm's benefit, contrary to the plaintiffs' expectations that the securities would be held for their benefit except to the extent they had outstanding margin loans. The district court believed the complaints failed to allege "the source of the understanding falsely created by defendants" that "defendants would act otherwise than they did," indicating that it believed the only possible sources of such an understanding would be "a fiduciary duty" or a "prior representation." 586 F. Supp. 2d at 181. Later in the opinion, the district court rejected the plaintiffs' allegation that RCM deceived them by not disclosing that RCM was not complying with Commission rules and "not properly protecting customer assets," stating that this argument was "squarely foreclose[d]" by this Court's decision in *Finnerty* because, under that decision, there must be an "*affirmative misrepresentation or act* that gave plaintiffs a false understanding concerning RCM's use of their assets." 586 F. Supp. 2d at 192 (emphasis added). The Commission is concerned because this language can be read, particularly in

light of the alleged wrongdoing in this case, to mean that, as a result of *Finnerty*, the shingle theory's implied representations, including the representation that a brokerage firm will not sell a customer's securities in order to convert the proceeds, are no longer a basis for a Section 10(b) fraud claim.

Contrary to the district court's apparent view, Section 10(b) broadly proscribes the use of "any manipulative or deceptive device or contrivance" as defined by Commission rules. *Zandford*, 535 U.S. at 819, quoting Section 10(b). As the Supreme Court emphasized in *Zandford*, among Congress' objectives in passing the Exchange Act was "'to insure honest securities markets'" and "'to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'" *Id*., quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (internal quotation marks and further citation omitted). "Consequently . . . [the Exchange Act, including Section 10(b)] should be 'construed not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Zandford*, 535 U.S. at 819, quoting *Affiliated Ute*, 406 U.S. at 151 (internal quotation marks and further citation omitted). This principle is particularly apt in cases involving alleged misconduct of broker-dealers, since "[t]here is no identifiable segment of the securities industry whose ethical conduct is more crucial to the attainment of

Congress' goals than the ethical conduct of broker-dealers." *Dirks v. SEC*, 681 F.2d 824, 841 (D.C. Cir. 1982, *rev'd on other grounds*, 463 U.S. 646 (1983).

Section 10(b) does not require that deception take a particular form in order to be actionable; it prohibits "'*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception.'" *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). 9/ Thus, Section 10(b) is not limited to cases, like *Zandford*, involving a fiduciary duty to disclose all material facts to a discretionary account customer and cases involving express misrepresentations. The Supreme Court has held to be actionable under Section 10(b) a non-fiduciary's conduct that was deceptive because it was inconsistent with an implied, rather than express, representation. *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 596-97 (2001) (entering into an option contract to sell a security with the secret intent not to honor the contract violated Section 10(b)). The Court's reasoning involved recognition of the common law principle that an implied

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9/ To the extent that the fraudulent conduct proscribed by Section 10(b) differs from common law fraud, Section 10(b) is broader. *Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988) (Section 10(b) is "in part designed to *add* to the protections provided investors by the common law" (emphasis added)); 7 Louis Loss & Joel Seligman, *Securities Regulation* 3419-3420 (3d ed. revised 2003).

representation is made when entering into a contract that one will fulfill his contractual promise. *Id*. at 596 (quoting Restatement (Second) of Torts § 530 cmt. c (1976): "Since a promise necessarily carries with it the *implied assertion* of an intention to perform[,] it follows that a promise made without such an intention is fraudulent" (emphasis added)). 10/

The Supreme Court and this Court have also held conduct to be actionable under Section 10(b) in other cases that involved neither a fiduciary duty nor any express misrepresentation. *See Affiliated Ute*, 406 U.S. at 153 (defendants violated Section 10(b) by failing to disclose to sellers their role in making a market for a stock (no discussion of fiduciary duty)), citing *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1170, 1171-72 (2d Cir. 1970) (expressly rejecting argument that broker owed fiduciary duty to customer, but holding nonetheless that firm violated Section 10(b) by failing to disclose the conflict of interest created by its status as marker-maker in securities that it recommended to customer). Thus, the district court in this case mistakenly imposed unwarranted limitations on the scope of Section 10(b) and

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10/ Implied representations made through conduct other than entering into a contract are also well recognized as the basis for a defendant's actions constituting common law fraud. *See Prosser and Keeton on Torts* § 106 at 736 (5th ed. 1984) ("Merely by entering into some transactions at all, the defendant *may reasonably be taken to represent that some things are true*–as for example, that a bank which receives deposits is solvent, or that a stock certificate sold is a valid one, and he has a permit to sell it" (emphasis added, footnotes and citations omitted)).

Rule 10b-5 by requiring (586 F. Supp. 2d at 181) that the complaints, in order to come within the scope of the statute and rule, allege a fiduciary duty or "an affirmative misrepresentation or act" (*id*. at 192) with which the defendants' alleged conduct was inconsistent.

The Commission has long held that by hanging out its professional shingle a broker-dealer makes the implied representation that it will treat customers "fairly, and in accordance with the standards of the profession." *Duker & Duker*, 6 S.E.C. 386, 388 & n.5 (1939) (reasoning that recognizing such an implied representation was similar to the established principle that "the mere act of keeping a bank open is a representation of its solvency" 11/); *accord Charles Hughes & Co.*, 13 S.E.C. 676, 679-80 (1943), *aff'd*, *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943); *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 192 (2d Cir. 1998). As a broker-dealer allegedly operating in the United States, RCM was subject to the shingle theory. The shingle theory "is not predicated upon the existence of a fiduciary obligation" and applies to all broker-dealer transactions "including those engaged in

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11/ In support, the Commission relied on *Raynor v. Scandinavian American Bank*, 122 Wash. 150, 210 P. 499 (1922); that state case in turn relied on *St. Louis & S. F. Ry. v. Johnston*, 133 U.S. 566, 577 (1890) (by continuing in business while insolvent, bank falsely "represented to [plaintiff], and all other persons dealing with it, that it was solvent," thereby rendering fraudulent bank's acceptance of plaintiff's deposit).

as 'dealer' or principal" (Ezra Weiss, *Registration and Regulation of Brokers and Dealers* 171 (1965)), and its implied representation extends to all customers, regardless of their "knowledge of the market or . . . access to market information" (*Charles Hughes*, 13 S.E.C. at 681). 12/ The Commission's formal adjudicatory decisions interpreting the shingle theory, like the Commission's other interpretations of the federal securities laws, are entitled to deference in the courts. *Zandford*, 535 U.S. at 819-820.

The shingle theory is often applied in excessive pricing cases, such as *Grandon*, but "[i]t is not possible to set limits on the variety of ways in which the sweeping representation implied by [the shingle theory] may be rendered false by a broker-dealer." Weiss, *Brokers and Dealers* at 171; *see also* 8 Louis Loss & Joel Seligman, *Securities Regulation* 3818-3823 (3d ed. revised 2004) ("Loss & Seligman"). Among the typical situations in which the shingle theory has been applied to render broker-dealer conduct deceptive under the antifraud provisions are a broker-dealer's "transaction of business with customers at a time when the broker-dealer is . . . insolvent or . . . he is unable to meet his current obligations as they

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12/ The fact that this brief does not address the fiduciary duty issue raised in this case should not be construed to indicate that the Commission believes that RCM had no fiduciary duty to safeguard securities that customers entrusted to RCM.

arise," 13/ the failure to make timely delivery of a security purchased and paid for by a customer, and "the hypothecation or other conversion to the broker-dealer's own use of fully-paid-for securities of customers held by the broker-dealer for safe-keeping." Weiss, *Brokers and Dealers* 172, 181-82. The latter conduct is inconsistent with longstanding professional standards and trade custom (as well as Commission rules) that require brokers to be able to deliver to a customer his fully paid securities and, upon his repayment of the margin loan, his margin securities. *See Richardson v. Shaw*, 209 U.S. 365, 378 (1908) (holding, based on well-settled principles established in New York cases, that when securities are purchased on margin the broker is a creditor to the extent he has loaned the customer the funds to purchase the securities, but the broker is a pledgee of the customer's margin securities, "carries the stock for the benefit of the purchaser," and may use the margin securities only in ways that do not interfere with the customer's ownership of the securities and ability to redeem them upon repayment of the margin loan); 7 Loss & Seligman 3157-59 (3d ed. revised 2003) (referring to Rule 15c3-3); *id*. at 3186 ("Even apart from statute, a broker is guilty of a conversion when, without a customer's consent, the broker hypothecates [a] customer's securities for loans in

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13/ *See, e.g.*, *Sanders Inv. Co.*, Release No. 34-6942, 1962 WL 68890 (Nov. 20, 1962); *W.F. Coley & Co.*, 31 S.E.C. 722, 726 (1950).

excess of the customer's indebtedness to [the broker]"); *id*. at 3169, 3170; Charles H. Meyer, *The Law of Stockbrokers and Stock Exchanges* 331-335 (1931) (absent specific written agreement, a broker may rehypothecate a customer's securities purchased on margin only up to the amount of the customer's debt to the broker "unless he does so under an arrangement permitting the withdrawal of the securities from his own pledgee on payment of the amount equal to the customer's indebtedness" so that the broker is able to deliver the securities to the customer upon the latter's payment of the margin loan). 14/

Without expressly referring to the shingle theory, in *Donald T. Sheldon*, 51 S.E.C. 59 (1992), *aff'd* 45 F.3d 1515 (11th Cir. 1995), the Commission found conduct similar to that alleged in the complaints at issue here–without disclosure, using customers' fully paid securities in repo transactions to obtain funds to stave off the brokerage firm's financial problems and failing to obtain possession of customer securities the firm had pledged to obtain loans to finance its operations–to violate "'trade custom'" and therefore to violate Section 10(b) and Rule 10b-5 (51 S.E.C. at 62 & n.10, quoting Weiss, *Brokers and Dealers* 181). In other words, by acting inconsistently with professional standards of fairness regarding the use of

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14/ This longstanding principle has been modified in Exchange Act Rule 15c3-3 (adopted in 1972) to allow brokers to hypothecate a customer's securities having a value up to 140% of the amount of the customer's margin loan.

customers' assets, the firm deceived customers. *See also*, *e.g.*, *Edward C. Jaegerman*, 46 S.E.C. 706, 708 & n.4 (1976); *Thompson & Sloan, Inc.*, 40 S.E.C. 451, 454 (1961); *Lewis H. Ankeny*, 29 S.E.C. 514, 516 (1949); *SEC v. Scott, Gorman Municipals, Inc.*, 407 F. Supp. 1383, 1387 (S.D.N.Y. 1975). 15/

The fraud committed by a broker-dealer acting contrary to the implied

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15/ *Bissell v. Merrill Lynch & Co.*, 937 F. Supp. 237 (S.D.N.Y. 1996), *aff'd*, 157 F.3d 138 (2d Cir. 1998), erroneously equated the shingle theory with fiduciary duty, stating that because fiduciary duty, shingle theory and "principles of 'trust and agency'" "all allege theories of fiduciary law" the three issues would be "resolved together." 937 F. Supp. at 245-46. The *Bissell* district court characterized the issue in that case as whether the defendant broker owed the plaintiffs "a fiduciary duty with respect to the collateral practices in question"–*i.e.*, the broker's failure to inform the customer about, and share with the customer, interest the broker earned by using cash collateral the customer had posted in connection with his short sales of securities. *Id.* at 246. It was in that context that *Bissell* agreed with the defendant's contention that "such a duty [*i.e.*, a fiduciary duty] arises–if at all–from the relationship with [the broker] recognized in [the] margin agreement, namely, that of debtor and creditor." *Id*. We are not aware, however, of any authority in the courts of appeals recognizing an exception to the shingle theory with respect to broker practices concerning margin accounts, and to the extent *Bissell* could be interpreted to have done so we do not think it would be persuasive. *Angelastro v. Prudential-Bache Securities, Inc.*, 764 F.2d 939 (3d Cir. 1985), although not relying on the shingle theory and expressly addressing only the "in connection with" requirement, held actionable under Section 10(b) "alleged misrepresentations and nondisclosures by a brokerage firm regarding the credit terms of a margin account" (*id*. at 941), noting that "several courts have found a broker's failure to explain the risks of trading on margin to be actionable under Rule 10b-5" (*id*. at 943), citing *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 619 (9th Cir. 1981). *See also Angelastro*, 764 F.2d at 944, citing *Establissement Tomis v. Shearson Hayden Stone, Inc.*, 429 F. Supp. 1355, 1361-63 (S.D.N.Y. 1978).

representation of the shingle theory is avoided only by "disclosing such information as will permit the customer to make an informed judgment upon whether or not he will complete the [contemplated] transaction." *Duker & Duker*, 6 S.E.C. at 389; *accord Grandon*, 147 F.3d at 192. Thus, in order to avoid acting deceptively under the shingle theory a broker-dealer would have to disclose to its customer with specificity any conduct the broker intended to engage in that was inconsistent with the implied representation. *See Pryor, McClendon, Counts & Co.*, 80 SEC Dkt. 1737 (June 26, 2003), 2003 WL 21468608, *3-*4 & n.4 (and cases cited therein).

Finally, contrary to the district court's view (586 F. Supp. 2d at 184-85), even where a broker properly hypothecates a customer's securities while a margin loan is outstanding, if the broker is unable to redeem the securities from hypothecation upon the customer's repayment of the margin loan (and therefore is unable to deliver the securities when the customer so requests), the broker acts deceptively at least from the time he accepts repayment of the margin loan without disclosing his inability to deliver the securities. *See Duker & Duker*, 6 S.E.C. at 389 (the shingle theory implied representation that the broker will treat the customer fairly "continued as long as it kept [the broker's customers] lulled, and *it became knowingly false the moment an intent to deal unfairly was formed*" (emphasis added)); *Prosser and Keeton on Torts* § 106 at 738 (5th ed. 1984) (one who has

made a representation and subsequently acquires new information that makes the prior representation misleading must disclose the new information to anyone whom he knows to be still acting on the basis of the original representation). The broker would thus be acting deceptively from that point forward and, if the other required elements were satisfied, Rule 10b-5 would be violated.

CONCLUSION

In reviewing the district court's dismissal of the complaints, this Court should apply the interpretations set forth in this brief.

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CERTIFICATE OF COMPLIANCE WITH FED. R. APP. P. 32(a)

I certify that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B); it contains 6,953 words, excluding the parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii). I also certify that this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and type style requirements of Fed. R. App. P. 32(a)(6) because the brief has been prepared using WordPerfect 11 in a proportionally spaced, 14-point typeface.

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CERTIFICATE OF SERVICE

I certify that on June 12, 2009, I caused the requisite number of copies of the foregoing brief to be dispatched to the Clerk of the Court via Federal Express overnight courier, and also caused two copies of the foregoing brief to be served on counsel for each party in these appeals via Federal Express overnight courier addressed as follows:

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