UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 84-5427

LAURA ANGELASTRO, on behalf of herself and all others similarly situated,

Plaintiff, Appellant, Cross-Appellee,

v.

PRUDENTIAL BACHE SECURITIES, INC., and BACHE HALSEY STUART SHIELDS, INC.,

Defendants, Appellees, Cross-Appellants.

On Appeal from the United States District Court for the District of New Jersey

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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QUESTION PRESENTED

Where a brokerage firm is alleged to have made misleading statements to a customer concerning the interest rates charged when securities are purchased on credit or "margin", were the alleged misrepresentations made "in connection with" the subsequent purchase of securities on margin, or the pledge of the securities as collateral for the margin loan, in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder?

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration of the federal securities laws, including the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., submits this brief as amicus curiae to address an issue of major importance to its administration of that Act. The district court dismissed plaintiff's claim under the antifraud provisions of Section 10(b) of the Act, 15 U.S.C. 78j(b), and Commission Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, on the ground that the alleged misrepresentations by the defendant brokerage firms concerning the interest rates charged on margin accounts were not "in connection with the purchase or sale of a security" as required by the statute and rule. According to the court, the "in connection with" requirement is not satisfied unless the misrepresentation relates to the "merits of particular securities."

The Commission believes that such a holding, if adopted by this Court, would have a serious detrimental effect on the Commission's regulation of the securities industry and unduly curtail the protections afforded investors by the antifraud provisions of the Act. Not all considerations which are material to a customer's decision to purchase securities through a broker relate to the investment value of the securities. Moreover, a substantial portion of a brokerage firm's dealings with its customers occur before any particular securities are identified for investment, or they relate, not to any particular securities transaction, but generally to the handling of the customer's securities account. Indeed, various rules adopted by the Commission under the antifraud provisions are directed towards conduct not related to the merits of particular securities.

Since investors deal with brokerage firms for the sole purpose of engaging in securities transactions, it is not an overstatement to assert that "a broker's activities are of necessity connected with the purchase and sale of securities." Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980). The reasoning of the district court would immunize many of a brokerage firm's dealings with its customers from the coverage of the federal securities laws and violate the Supreme Court's repeated admonition that the federal securities laws were intended "to achieve a high standard of business ethics * * * in every facet of the securities industry." United States v. Naftalin, 441 U.S. 768, 775 (1979) (emphasis in original), quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963); cf. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

As amicus curiae, the Commission expresses no view on the merits of the factual allegations in the complaint, and will address only the legal issue presented by this appeal. 1/

STATEMENT OF THE CASE

1. The Complaint

Plaintiff Laura Angelastro instituted this action by filing a complaint in the District Court for the District of New Jersey, alleging that defendants

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1/ The complaint also alleged a violation of Commission Rule 10b-16, 17 C.F.R. 240.10b-16, which, in contrast to the general antifraud prohibitions of Rule 10b-5, imposes specific disclosure requirements on broker-dealers relating to margin interest rates. The district court held, in upholding plaintiff's claim under Rule 10b-16, that a private right of action exists under that Rule. That holding is the subject of the cross-appeal in this case. The Commission intends to file a separate amicus curiae brief in that cross-appeal addressing the Rule 10b-16 private right of action issue.

Prudential-Bache Securities, Inc. and its predecessor, Bache Halsey Stuart Shields, Inc. (hereafter cumulatively referred to as "Bache"), violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. Ms. Angelastro seeks to represent a class consisting of all persons who purchased securities from January 1, 1977 to December 31, 1982 through margin accounts maintained with the defendants.

The complaint alleged that Bache engaged in a fraudulent course of business, the purpose and effect of which were to induce plaintiff and other class members to purchase securities from Bache for excessive consideration (C. 5, 8). 2/ The alleged fraud consisted of Bache's intentional concealment of, and failure to disclose, material facts necessary in order to render not misleading certain statements made to margin customers in customer account agreements and other documents, concerning the interest rates that would be charged on margin accounts (C. 5). 3/ The fraud allegedly was utilized by Bache to induce customers to purchase various securities through Bache (C. 5). The plaintiff seeks judgment for damages and an order enjoining further violations.

2/ "C. __" refers to the complaint; "Op. __" refers to the opinion of the district court.

3/ Specifically, plaintiff alleges that defendants failed to disclose the interest rate that Bache would charge, the index to which that rate would be tied, and the relationship between that rate and Bache's broker's call rate; the formula by which interest rates would be assessed; that certain credit balances in margin accounts would have to be transferred to other accounts in order for interest to be paid by Bache upon such credit balances; that increases in the market value of underlying securities in connection with which credit was extended would not be considered in determining the extent of credit or in calculating interest charges to be assessed against margin accounts; that interest rates on margin accounts were variable, and that alternate and lower interest rates were available at the firm (C. 6, 7).

2. Proceedings in the District Court

On motion by defendants to dismiss the Rule 10b-5 allegations for failure to state a claim, the district court dismissed the Rule 10b-5 claim. 4/ The court held that the conduct complained of, which concerned only the interest rates charged on margin accounts, was not actionable under Rule 10b-5 because it was not "in connection with" the purchase and sale of any security (Op. 5). Characterizing Rule 10b-5 as "primarily a protection against fraud concerning the *merits* of *particular securities*" (Op. 5-6; emphasis supplied), the court cited, as grounds for its dismissal of the 10b-5 claim, the plaintiff's failure to allege misrepresentations about any particular securities (Op. 5).

ARGUMENT

MISLEADING STATEMENTS MADE BY A BROKERAGE FIRM TO A CUSTOMER CONCERNING INTEREST RATES CHARGED ON MARGIN ACCOUNTS ARE "IN CONNECTION WITH" THE CUSTOMER'S PURCHASE AND SALE OF SECURITIES.

Section 10(b) of the Securities Exchange Act and Rule 10b-5, which together this Court has characterized as a "cornerstone of the federal program of securities regulation" (*Ketchum v. Green*, 557 F.2d 1022, 1025 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977)), make it unlawful to engage in fraudulent conduct "in connection with the purchase or sale of any security." In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the leading Supreme Court case interpreting the "in connection with" require-

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4/ The district court, in contrast, upheld most of plaintiff's allegations that the nondisclosures violated Rule 10b-16, holding that a private right of action should be implied under that Rule (Op. 6-7). The court, however, dismissed other portions of the Rule 10b-16 claim on the ground that certain of the allegedly undisclosed information was not required to be disclosed by the Rule.

ment, the Court emphasized the need to read Section 10(b) "flexibly, not technically and restrictively." Id. at 12. See also Herman & MacLean v. Huddleston, 459 U.S. 375, 386-87 (1983); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

In Superintendent of Insurance, the Court held that the "in connection with" requirement is satisfied where the party is defrauded "as a result of deceptive practices touching its sale of securities * * *." 404 U.S. at 12-13. This Court has interpreted the "touching" test as contemplating a "causal connection" between the fraudulent act or omission and the purchase or sale of a security. Ketchum v. Green, 557 F.2d at 1028, citing Tully v. Mott Supermarkets, Inc., 540 F.2d 187, 194 (3rd Cir. 1976). The Second Circuit has similarly applied a causation standard, holding that it is sufficient that the representation "be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). 5/

5/ The Fifth Circuit has held that "[t]he plaintiff need not establish a direct or close relationship between the fraudulent transaction and the purchase or sale * * *." Alley v. Miramon, 614 F.2d 1372, 1378, n.11 (5th Cir. 1980). Rather, the requirement that the deceptive practices "touch" the sale or purchase of securities is "satisfied when the proscribed conduct and the sale are part of the same fraudulent scheme." Id. at 1378 n.11.

1. Where, as Here, Statements Concerning the Terms of Credit Offered by a Brokerage Firm Would Induce a Customer to Purchase Securities on Margin, those Representations are "In Connection With" the Customer's Purchase of Securities.

The requisite connection between the alleged misrepresentations and the purchase of securities is satisfied in this case. The complaint, the well-pled allegations of which must be accepted as true in deciding a motion to dimiss, 6/ expressly alleged that

> Bache, among other matters, engaged in acts, transactions, practices, and courses of business which operated as a fraud and deceit upon plaintiff and other customers of Bache * * * the purpose and effect of which were to induce plaintiff and other class members to purchase various securities through Bache and to make such purchases for excessive consideration.

C. 5 (emphasis supplied). Indeed, a broker's misrepresentations of material facts about interest rates on margin accounts should always be considered to be "in connection with" the subsequent purchases of securities on margin. Information with respect to the interest rates charged by a broker on margin accounts is provided to a brokerage customer to permit the customer to evaluate the desirability of purchasing securities on margin. Customers maintain margin accounts for the very purpose of trading in securities. Since the terms of credit offered by the broker affect the ultimate profitability of the investment, representations concerning margin rates can plainly affect a decision whether to purchase on margin and therefore are properly viewed as causing the subsequent purchases. Indeed, the connection between the misrepresentation and the securities purchased is made evident by the fact that, in a case like

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6/ See, e.g., Miree v. De Kalb County, 433 U.S. 25, 27, n.2 (1977); Rogin v. Bensalem Township, 616 F.2d 680, 685 (3d Cir. 1980); Bogosian v. Gulf Oil Corp., 561 F.2d 434, 444 (3d Cir. 1977).

the one alleged here, the brokerage firm profits from its fraud, and the customer is harmed, only to the extent the customer determines to trade in securities on margin.

In Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615 (9th Cir. 1981), the Ninth Circuit affirmed the district court's finding that an account executive's failure to disclose to his customer the risks of margin investing was fraud in connection with the purchase of securities. 651 F.2d at 619. Rejecting the defendant's assertion -- like that adopted by the district court here -- that the "fraud committed was in connection with the method of financing the purchase of securities, not with the purchase itself" (651 F.2d at 619), the court held that the misrepresentations satisfied the "in connection with" requirement, since those misrepresentations were part of

> a scheme to induce Arrington to borrow money from Merrill Lynch to engage in commission-producing securities purchases through Merrill Lynch. The trial court properly found fraud "in connection with" the sale of securities.

Id. Like the misrepresentations concerning the risks of margin investing at issue in Arrington, misrepresentations concerning the interest rates charged on margin accounts are made to induce customers to purchase securities through the brokerage firm. See Steinberg v. Shearson Hayden Stone, Inc., [1982] Fed. Sec. L. Rep. (CCH) ¶98,868 (D. Del. 1982) (upholding Rule 10b-5 claim for misrepresentation of margin rates). See also Goldberg v. National Bank of North America, [1970] Fed. Sec. L. Rep. ¶92,555 (S.D.N.Y. 1970) (upholding Rule 10b-5 claim for misrepresentation of margin requirements). By attempting to distinguish Arrington on the basis that "there is a difference between misrepresentations concerning credit terms of margin accounts and misrepresentations concerning the nature of trading on margin in a particular climate"

(Op. 3-4; emphasis in original), the district court ignored the fact that both types of information are important considerations to investors in deciding to buy securities on margin. Indeed, information concerning what margin rate a particular brokerage firm will charge on margin transactions through that firm, should be viewed as more closely connected with the margin transaction than information concerning the risks of margin investing generally.

2. The District Court Erred in Concluding that Misrepresentations Must Relate to the Merits of Particular Securities In Order to Satisfy the "In Connection With" Requirement of Rule 10b-5.

The district court believed that the fraud must concern the merits of a particular security in order to satisfy the "in connection with" requirement (Op. at 5). Yet courts which have considered the "in connection with" issue have uniformly rejected a requirement that the fraud relate to the merits of any security, as well as a requirement that the fraud relate to a particular security.

With respect to a "merits" element, the Supreme Court in Superintendent of Insurance squarely rejected any such requirement. In that case, the Court held that Rule 10b-5 was violated when a seller of Treasury Bonds was duped into believing that it, the seller, would receive the proceeds from an otherwise legitimate sale of the bonds. The Supreme Court rejected the argument that there could be no Rule 10b-5 fraud because the securities transaction itself had been entirely proper. The Court held that it was sufficient to establish a Rule 10b-5 claim to show that a party "suffered an injury as a result of deceptive practices touching its sale of securities as an investor." 404 U.S. at 12-15. The Supreme Court's holding in Superintendent of Insurance thus dispels any notion that the misrepresentations must concern the value of the securities sold (Op. 5). 7/

Likewise rejecting a "merits" requirement, the Second Circuit in Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980), affirmed the district court's holding that a brokerage firm trainee was liable under Rule 10b-5, where the trainee's false representation that he was a stock broker and a "portfolio management specialist" caused the plaintiffs to purchase securities which subsequently declined in value. The court held that the misrepresentation was "in connection with" the plaintiffs' purchase of the securities, since the misrepresentation induced them to purchase those securities in reliance on the trainee's supposed expertise. 629 F.2d at 707, 710. The "in connection with" requirement was held to be satisfied even though, as the court noted, the misrepresentations alleged did not relate to "an element of value intrinsic to the worth of the security * * *." 629 F.2d at 708. The court specifically declined to adopt a new rule

> effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in. So concise a theory of liability for fraud would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction.

629 F.2d at 710. See also A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d

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7/ In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the Supreme Court reaffirmed Superintendent of Insurance and held that a bank violated Rule 10b-5 when it failed to disclose to customers for whom it executed securities transactions that it was a market maker in the stock traded. Id. at 153, citing Chasins v. Smith Barney & Co., 438 F.2d 1167 (2d Cir. 1970) (brokerage firm's failure to disclose that it was acting as a principal violated Rule 10b-5).

Cir. 1967) ("[A] 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value'").

The district court's view that the fraudulent conduct must be in connection with a particular security is likewise unsupported by the case law. That requirement was rejected in Arthur Lipper Corporation v. SEC, 547 F.2d 171 (2d Cir. 1976), which involved a brokerage firm's commission policies. The court stated (id. at 176):

> There is some initial surprise in seeing Rule 10b-5 invoked where the fraud relates not, as in the usual case, to a particular securities transaction but to a course of dealing in securities regardless of their identity. However, the language of the Rule is broad enough to include the latter type of case and petitioners do not urge that the Rule has no application to a course of dealing where the fraud concerns the overall relation of broker and customer rather than the overvaluation or undervaluation of a security sold or purchased.

And, in In re Catanella and E.F. Hutton & Co., Inc., Securities Litigation, [Current] Fed. Sec. L. Rep. (CCH) ¶91,497 (E.D. Pa. 1984), the court held that a broker's misrepresentations to his clients concerning the risks of margin trading were in connection with the clients' subsequent purchases of securities from the broker. Id. at 98,486. The court emphasized that fraud, to be actionable, need not relate to the purchase of a particular security (id.):

> Although the failure to disclose did not necessarily result in the purchase of a specific security, it did cause plaintiffs to purchase more securities than they otherwise would have. Thus, plaintiffs unwittingly exposed themselves to more potential liability because of the increased trading a margin account permits. The failure to disclose certainly "touches" the securities so purchased.

The district court here was concerned that, if misrepresentations that the court viewed as being only tangentially related to a securities transaction could give rise to a Rule 10b-5 action against a broker-dealer, such misconduct could also provide a basis for liability even when they occur outside the brokerage context, thus increasing the reach of the federal securities laws. But the brokerage industry has traditionally been held to special scrutiny under the federal securities laws, which impose a myriad of duties on broker-dealers not imposed on persons outside the brokerage industry. The Supreme Court has stressed that the federal securities laws were designed "'to achieve a high standard of business ethics * * * in every facet of the securities industry.'" U.S. v. Naftalin, 441 U.S. 768, 775 (1979) (emphasis in original), quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963). Cf. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). And the Ninth Circuit stated in Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980), that "a broker's activities are of necessity connected with the purchase and sale of securities." Accordingly the courts have required, under the securities laws, that broker-dealers meet a high standard of conduct in all aspects of their dealings with customers. This standard is generally encompassed by the long-established obligation of the broker-dealer to deal fairly and honestly with its customers. See Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943); In re Duker & Duker, 6 S.E.C. 386, 388 (1939). Cf. Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975) (brokerage firm strictly liable for acts of employees because of "the special responsibility they owe to their customers").

Since persons outside the brokerage industry are not ordinarily held to the same stringent standards, Rule 10b-5 will not necessarily apply with the same force with respect to those persons. On the other hand, to allow a brokerage firm to mislead its customers in the manner alleged in the complaint here without invoking the antifraud provisions of the federal securities laws would "leave such legislation little more than a snare and a delusion." Charles Hughes & Co. v. SEC, 139 F.2d at 438. Many aspects of a firm's dealings with its customers would be immunized from the coverage of the antifraud provisions, since they do not relate to the merits of particular securities transactions. Thus, under the district court's reasoning, a securities salesman who misappropriates the proceeds from the sale of securities 8/ would not violate Rule 10b-5. Such commonly recognized Rule 10b-5 violations as churning, 9/ unauthorized trading, 10/ and undisclosed commissions 11/ could fall outside the scope of the Rule. Other fraudulent practices such as remote checking by brokerage firms, 12/ failure to transfer accounts on a timely basis, 13/ and doing business while insolvent, 14/ could escape scrutiny.

8/ See Henricksen v. Henricksen, 640 F.2d 880 (9th Cir.), cert. denied, 454 U.S. 1097 (1981). See also Superintendent of Insurance, 404 U.S. at 12-13.

9/ See Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980); In re Catanella and E.F. Hutton & Co, Inc., Securities Litigation [Current] Fed. Sec. L. Rep. (CCH) ¶91,497 at 98,484 (E.D. Pa. 1984); Yancoski v. E.F. Hutton & Co., Inc., 581 F. Supp. 88, 91-92 (E.D. Pa. 1983).

10/ See R.A. Holman & Co. v. SEC, 366 F.2d 446 (2d Cir. 1966).

11/ See SEC v. Geo Dynamics Oil & Gas, Inc., [1978] Fed. Sec. L. Rep. (CCH) ¶96,428 (D.D.C. 1978). But see Williamsport Firemen Pension Boards I and II v. E.F. Hutton & Co., Inc., [1982-83] Fed. Sec. L. Rep. (CCH) ¶99,268 (M.D. Pa. 1983), discussed infra pages 15-16.

12/ See SEA Release No. 34-15194 (Sept. 28, 1978), 15 SEC Docket 1174-76.

13/ Id.

14/ See SEC v. G. Weeks Securities, Inc., 678 F.2d 649 (6th Cir. 1982); In re Wolfram, SEA Release No. 19653 (April 5, 1983), 27 SEC Docket 1016-21.

Indeed, adoption by this Court of the district court's holding that the fraud must relate to the merits of particular securities would threaten a number of the Commission's rules adopted under Section 10(b) of the Securities Exchange Act, such as Rule 10b-10, 17 C.F.R. 240.10b-10, requiring delivery of confirmations and disclosure of the firm's status as agent or principal in the trade. These types of required disclosure do not relate to the merits of the securities traded. 15/

The court below relied on several decisions which are readily distinguishable from the instant case. In Wilson v. First Houston Investment Corp., 566 F.2d 1235 (5th Cir. 1978), the plaintiff transferred control of his entire portfolio to an investment management company after a respresentative of the company assured him of the accuracy of articles describing the company's sophisticated computer investment analysis system. The representative failed to inform the plaintiff that the system was no longer in use. When the value of the portfolio dropped sharply, the plaintiff brought an action alleging, among other things, violations of Rule 10b-5. The Fifth Circuit held that, given the grant of discretionary trading authority to the defendant, defendant's trading in the plaintiff's stock was "too remote" from the misrepresentation to satisfy the "in connection with" requirement. 566 F.2d at 1243. See also O'Brien v. Continental Illinois National Bank, 593 F.2d 54,

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15/ One of the ironies of the district court's opinion is that it upheld parts of plaintiff's Rule 10b-16 claim when, if the court's reasoning with respect to Rule 10b-5 is correct, the Commission presumably did not have authority under Section 10(b) to adopt Rule 10b-16, since margin cost disclosures do not relate to the "merits" of any securities transaction and thus, in the court's view, would not be made in connection with the purchase and sale of securities.

63 (7th Cir. 1979); Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir.), cert. denied, 436 U.S. 905 (1978). The facts in Wilson are distinguishable from the instant case. Unlike the situation in Wilson, there was no transfer of discretion and control from the plaintiff to the defendant firm. The misleading disclosures concerning the margin interest rates thus related to each decision by plaintiff to purchase securities on margin.

Drasner v. Thomson McKinnon Securities, Inc., 433 F. Supp. 485 (S.D.N.Y. 1977), also cited by the district court, is similarly distinguishable. In Drasner, the court dismissed the Rule 10b-5 complaint of sophisticated options traders who sought damages for losses sustained allegedly as a result of the defendant's failure to inform them that their margin account was required to contain enough collateral to cover any deficiency, should options they had sold be exercised. 433 F. Supp. at 502. The court held that the broker's failure to disclose the margin requirement was not deceptive conduct, since the plaintiffs were fully aware of the requirement. Id. Since the court dismissed the claim on the ground that no deception existed, it never reached the question whether the asserted fraud would have been "in connection with" the sale of the options. 16/

A final case cited by the district court, Williamsport Firemen Pension Boards I and II v. E.F. Hutton & Co., Inc., [1982-83] Fed. Sec. L. Rep. (CCH) ¶99,268 (M.D. Pa. 1983), held that misrepresentations by a brokerage firm

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16/ The Drasner court also noted that the margin requirement "had no financial connection with plaintiff's gains or losses which were solely in conjunction with the price movements of the underlying stock." Id. at 503. This was a reference to the requirement in a Rule 10b-5 damage action that the fraud be the proximate cause of the plaintiff's loss, an issue not presented in this appeal.

officer of the amount and method of calculating his firm's commissions had "no causal connection to the purchase * * * of any particular securities." Id. at 96,208. The basis for this holding is not clear. However, to the extent that the holding was based on the plaintiffs' apparent failure to allege that the officer's misrepresentations induced the plaintiffs to purchase securities, it is distinguishable from the instant case (see supra page 7). To the extent that the opinion may hold that misrepresentations with respect to brokerage commissions can never be in connection with the purchase or sale of securities, the case was incorrectly decided for the reasons set forth in this brief, and this Court should reject its reasoning as an unduly narrow construction of Rule 10b-5.

3. The Alleged Misrepresentations Concerning the Interest Rates on Margin Loans Were In Connection With a Purchase or Sale of a Security, Since they Were In Connection With the Customer's Pledge of Securities as Collateral for those Loans.

The alleged misleading statements concerning margin loan interest rates, aside from being in connection with plaintiff's purchase of securities on margin, certainly were related to the pledge of securities as collateral for the margin loans. Since the pledge itself constituted a sale, 17/ those misrepresentations were "in connection with" a sale of securities.

The principle that a pledge of securities constitutes a sale by the borrower and a purchase by the lender was critical to the holding in United States v. Kendrick, 692 F.2d 1262 (9th Cir. 1982), cert. denied, 103 S. Ct. 1892 (1983). In Kendrick, a stockbroker withdrew funds from his customer's

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17/ See Rubin v. United States, 449 U.S. 424 (1981); Marine Bank v. Weaver, 455 U.S. 551, infra n.18 (1982).

margin account at another brokerage firm and deposited those funds in his own bank account. He then falsely represented to that firm and the customer that the funds were used to purchase securities for the customer. 692 F.2d at 1264. In accordance with the stockbroker's misrepresentations, the brokerage firm recorded the transaction as a loan, and then took a pledge of securities held in the margin account as collateral for the new "loan". Id.

The Ninth Circuit affirmed the district court's holding that the broker's conduct violated Rule 10b-5. The court found that the broker's fraudulent misrepresentation to the firm caused the firm to further collateralize the customer's loan, and was thus "in connection with" that "sale" of securities to the firm. 692 F.2d at 1266. A similar result is dictated here. Since defendants' alleged misrepresentations concerning the interest rates caused plaintiff to pledge securities as collateral for the margin loans, the misrepresentations were thus in connection with the pledge-sale of those securities to defendants. 18/

18/ See also Weaver v. Marine Bank, 637 F.2d 157, 161 (3d Cir. 1980), rev'd on other grounds, 455 U.S. 551 (1982) (bank's misrepresentation concerning third party's business which caused the plaintiff to pledge a certificate of deposit to secure a guarantee of loan to third party, was in connection with the sale of the certificate of deposit). Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984), is not to the contrary, since it expressly distinguished the situation in Weaver (and thus the type of situation present here) in ruling that the "in connection with" requirement was not satisfied in a pledge transaction. Moreover, unlike the case in Chemical Bank, where the court was influenced by the fact that it was entirely fortuitous that securities were used to collateralize the bank loan at issue there (id. at 944), margin loans invariably involve the pledge of securities.

CONCLUSION

For the foregoing reasons, this Court should hold that misrepresentations made by a brokerage firm to a customer concerning interest rates charged on margin accounts are in connection with the purchase and sale of securities within the meaning of Section 10(b) of the Securities Exchange Act and Rule 10b-5.

Respectfully submitted,

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September 1984

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

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CERTIFICATE OF SERVICE

I hereby certify that I have today caused two (2) copies of the Brief of the Securities and Exchange Commission, Amicus Curiae, to be served by mail, first class, government frank, on counsel for the parties as follows:

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