

## Casenote

### ***SEC v. Zandford*: A Stockbroker's Coincidental Encounter With the “In Connection With” Requirement of Section 10(b)**

In *SEC v. Zandford*,<sup>1</sup> the United States Supreme Court held that when a stockbroker sells his customer's stock with the intent to steal the proceeds, his breach of fiduciary duty and misappropriation of funds constitutes a fraud “in connection with” the sale of the securities in violation of section 10(b) of the Securities Exchange Act of 1934.<sup>2</sup> In so holding, the Court set forth a new test to determine whether a fraud is perpetrated “in connection with” the purchase or sale of a security: If a fraudulent scheme “coincides” with the purchase or sale of a security, such fraud is “in connection with” the purchase or sale for purposes of section 10(b) and Rule 10b-5.<sup>3</sup>

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1. 535 U.S. 813, 122 S. Ct. 1899 (2002).

2. *Id.* at 1903. Section 10(b) of the Securities Exchange Act of 1934 is codified as amended at 15 U.S.C. § 78j(b) (2001).

3. *See* 122 S. Ct. at 1906. Rule 10b-5 is codified at 17 C.F.R. § 240.10b-5 (2002).

## I. FACTUAL BACKGROUND

In 1987 securities broker Charles Zandford persuaded William Wood to open a joint investment account. Mr. Wood was an elderly man in poor health, and he opened the investment account for himself and his mentally retarded daughter. The stated objectives of the account were to secure the principal and to earn a modest amount of income. To this end, the Woods left the management of their account to Zandford's discretion and gave Zandford a general power of attorney to conduct securities transactions on their behalf without prior approval. The Woods entrusted Zandford with \$419,255. By 1991 this money was gone.<sup>4</sup>

The National Association of Securities Dealers discovered that Zandford had misappropriated the Woods' money by repeatedly selling the Woods' securities and transferring the proceeds to accounts owned or controlled by himself. Zandford was indicted on thirteen counts of wire fraud in violation of 18 U.S.C. § 1343 and was convicted on all thirteen counts.<sup>5</sup>

After Zandford's indictment, the Securities and Exchange Commission ("SEC") filed a civil complaint, alleging that Zandford violated section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5 by engaging in a scheme to defraud the Woods by misappropriating their money for his own use. Once Zandford was convicted, the SEC filed a motion for partial summary judgment, maintaining that the conviction conclusively established facts showing a violation of section 10(b). The district court granted the SEC's motion for partial summary judgment, and Zandford appealed.<sup>6</sup>

The United States Court of Appeals for the Fourth Circuit reversed the district court's grant of partial summary judgment and remanded the case with instructions to dismiss the complaint for failing to state a claim upon which relief could be granted. Specifically, the court decided that the complaint failed to allege the necessary connection between Zandford's fraud and his sale of the Woods' securities because the misappropriation of the Woods' money was separate from Zandford's sale of securities.<sup>7</sup>

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4. 122 S. Ct. at 1901.

5. *Id.*

6. *Id.*

7. *Id.* at 1901-02.

The United States Supreme Court granted certiorari to determine whether Zandford's fraudulent scheme to misappropriate the proceeds occurred "in connection with" the sale of the securities.<sup>8</sup> In a unanimous decision, the Court reversed the holding of the Fourth Circuit and concluded that the factual allegations met the "in connection with" requirement of section 10(b) because the alleged fraud coincided with Zandford's sale of the Woods' securities.<sup>9</sup>

## II. LEGAL HISTORY

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for any person to "use or employ, 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 Commission may prescribe."<sup>10</sup> Pursuant to the rule-making authority granted by this statute, the SEC promulgated Rule 10b-5, which states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with* the purchase or sale of any security.<sup>11</sup>

Section 10(b) and Rule 10b-5 thus prohibit fraud that is perpetrated "in connection with" the purchase or sale of a security. The language of the statute and the rule, however, offers little guidance as to the meaning of the "in connection with" requirement. Courts have consequently found it increasingly difficult to determine when a fraud is, in fact, perpetrated "in connection with" the purchase or sale of a security.

Jurisprudence of the "in connection with" requirement began simply enough with a case asking whether plaintiffs in a Rule 10b-5 action

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8. *Id.* at 1902.

9. *Id.* at 1906.

10. 15 U.S.C. § 78j(b).

11. 17 C.F.R. § 240.10b-5 (emphasis added).

must be actual purchasers or sellers of securities.<sup>12</sup> The United States Court of Appeals for the Second Circuit answered this question in the affirmative, holding that protection under Rule 10b-5 is limited to actual, as opposed to prospective, purchasers and sellers.<sup>13</sup> The holding in *Birnbaum v. Newport Steel Corp.*<sup>14</sup> was not surprising given that the statute and the rule speak only of actual purchases and sales; but the court went on to conclude that section 10(b) “was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs.”<sup>15</sup> This conclusion represented the first of many attempts to delineate the scope of the “in connection with” requirement. The court determined that fraud would not be deemed “in connection with” the purchase or sale of a security if it amounted to nothing more than corporate mismanagement and that the requirement would remain unmet unless the fraud were of a type “usually associated” with the purchase or sale of securities.<sup>16</sup> In light of what was to come, this definition of the nexus requirement was a narrow one.

Sixteen years later, applying the “in connection with” requirement to a dissimilar set of facts, the Second Circuit appeared to read the statute more broadly.<sup>17</sup> In *SEC v. Texas Gulf Sulphur Co.*,<sup>18</sup> the court held that defendants in a Rule 10b-5 action need not have participated in the purchase or sale of a security in order to have perpetrated a fraud in connection therewith.<sup>19</sup> Plaintiffs in *Texas Gulf* were stockholders who alleged they were defrauded by company officers when the officers issued a misleading press release regarding the company’s success in oil exploration activities. Defendants did not actually participate in the purchase or sale of the securities, but they did convey false information to the investing public anticipating that the public would enter into securities transactions in reliance thereon.<sup>20</sup> The court concluded that defendants’ fraudulent acts were “in connection with” the purchase or sale of securities, notwithstanding their lack of participation, because defendants’ false statements were made “in a manner reasonably calculated to influence the investing public.”<sup>21</sup> Thus, while the holding

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12. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).

13. *Id.* at 464.

14. 193 F.2d 461 (2d Cir. 1952).

15. *Id.* at 464.

16. *Id.*

17. See *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 858-62 (2d Cir. 1968).

18. 401 F.2d 833 (2d Cir. 1968).

19. *Id.* at 860-62.

20. *Id.* at 839-42.

21. *Id.* at 861-62.

in *Birnbaum* narrowed the scope of Rule 10b-5 by requiring that plaintiffs be actual purchasers or sellers of securities,<sup>22</sup> the holding in *Texas Gulf* expanded the scope of the rule by bringing within its purview defendants who were neither purchasers nor sellers of the securities relating to the fraud.<sup>23</sup>

Three years later the United States Supreme Court addressed the “in connection with” requirement for the first time.<sup>24</sup> In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,<sup>25</sup> Manhattan Casualty Company (“Manhattan”) brought suit when the company discovered it had been defrauded by its managers. As part of an elaborate scheme, the managers of Manhattan agreed to sell all of Manhattan’s stock to Begole for five million dollars. Begole, acting with co-conspirators, used U.S. treasury bonds owned by Manhattan to pay for the stock. Through a sophisticated and deceptive series of transactions, Manhattan’s bonds were sold and the proceeds of the bonds were used to purchase Manhattan’s stock. In this manner, defendants defrauded Manhattan by using Manhattan’s assets to purchase Manhattan’s stock.<sup>26</sup> The district court and the court of appeals concluded that the fraudulent scheme was not perpetrated “in connection with” the purchase or sale of any security because the securities transactions, by themselves, were lawful and defendants’ misappropriation of plaintiffs’ assets, though fraudulent, was separate from the sale of the securities.<sup>27</sup> The Supreme Court disagreed.<sup>28</sup>

In a unanimous opinion by Justice Douglas, a former Chairman of the SEC, the Court concluded that the “in connection with” requirement was satisfied because Manhattan was “injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities.”<sup>29</sup> Though the Court concurred with the *Birnbaum* dicta by stating that fraud amounting to mere internal corporate mismanagement would not be deemed “in connection with” the purchase or sale of a security,<sup>30</sup> the Court ultimately deemed it irrelevant that the fraud was perpetrated by a corporate officer of

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22. See 193 F.2d at 464.

23. See 401 F.2d at 861-62.

24. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

25. 404 U.S. 6 (1971).

26. *Id.* at 7-9.

27. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 360 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971).

28. 404 U.S. at 12-13.

29. *Id.* at 10.

30. *Id.* at 12. The concurrence with the *Birnbaum* dicta was implicit, as the Court neither discussed nor cited to *Birnbaum* at any point in its opinion. See *id.* at 12, 7-14.

Manhattan because defendants' actions went beyond corporate mismanagement.<sup>31</sup> Also irrelevant were the facts that (1) the securities transaction relating to the fraud was not conducted through a securities exchange or over-the-counter market,<sup>32</sup> and (2) the victims of the fraud were corporations and ultimately creditors rather than individual investors.<sup>33</sup> Finally, because defendants' fraud related to the recipients of the proceeds of the sale, the Court's holding established that the "in connection with" requirement did not mandate that the deception relate to the value of the security being purchased or sold.<sup>34</sup>

In summarizing the Court's rationale in *Bankers Life*, Justice Douglas stated, "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor."<sup>35</sup> It was this statement that had the effect of significantly expanding the scope of Rule 10b-5.<sup>36</sup> Lower courts seized upon the "touching" language and took from it the rule that a fraudulent act is "in connection with" the purchase or sale of a security if the act "touches" the purchase or sale of a security.<sup>37</sup> Thus, while the actual holding in *Bankers Life* was unremarkable,<sup>38</sup> the case expanded the scope of Rule 10b-5.

Serving to tighten the reigns on Rule 10b-5 application was the Supreme Court's holding in *Blue Chip Stamps v. Manor Drug Stores*<sup>39</sup> four years later. In *Blue Chip Stamps*, plaintiff's complaint alleged that defendants violated Rule 10b-5 when defendants prepared a materially misleading prospectus "in connection with" a stock offering. The prospectus gave an overly pessimistic appraisal of defendants' status that was allegedly intended to discourage plaintiff from accepting a bargain offer so that the rejected shares might later be offered to the public at a higher price. Plaintiff relied on defendants' misleading prospectus, rejected the offer, and later sued defendants for the lost

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31. *Id.* at 10.

32. *Id.*

33. *Id.* at 12.

34. *See, e.g.,* Sargent v. Genesco, Inc., 492 F.2d 750, 763 (5th Cir. 1974).

35. 404 U.S. at 12-13.

36. *See* Ketchum v. Green, 557 F.2d 1022, 1026 (3d Cir. 1977) (discussing trend of courts' loose interpretation of the "in connection with" requirement that followed *Bankers Life*).

37. *See, e.g.,* Sargent, 492 F.2d 750.

38. The case was "a simple one in which a seller of securities was deceived by the buyer into parting with his securities for no consideration." C. Edward Fletcher, *The "In Connection With" Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913, 925 (1989).

39. 421 U.S. 723 (1975).

opportunity to purchase the shares.<sup>40</sup> The Court held that plaintiff's complaint failed to state a claim under Rule 10b-5 because plaintiff was not an actual purchaser or seller of the securities.<sup>41</sup> The Court thus adopted the rule set forth by the Second Circuit in *Birnbaum*: protection under Rule 10b-5 is limited to actual, as opposed to prospective, purchasers and sellers of securities.<sup>42</sup>

Perhaps of greater significance was the Court's tone in *Blue Chip Stamps*, which indicated a much narrower approach to the "in connection with" requirement than the Court's tone in *Bankers Life*.<sup>43</sup> As one commentator noted, the Court in *Bankers Life* was "almost cavalier" in reaching its holding that the "in connection with" requirement was satisfied.<sup>44</sup> In *Blue Chip Stamps*, however, the Court went through a much more thorough analysis of whether the "in connection with" requirement was met and expressed a great deal of concern over opening the door for "vexatious" litigation and other potential forms of abuse of the statute.<sup>45</sup> The Court emphasized, "[T]he wording of [section] 10(b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large."<sup>46</sup> In spite of this narrowing tone, however, lower courts continued to rely on the "touching" language of *Banker's Life* and interpreted the "in connection with" requirement quite loosely.<sup>47</sup>

Almost twenty years after *Blue Chip Stamps* was decided, the Court further limited the scope of Rule 10b-5 in *Central Bank of Denver v. First Interstate Bank of Denver*<sup>48</sup> by holding that the rule did not apply to those who aid or abet fraud.<sup>49</sup> Though the Court did not analyze the issue in terms of whether the acts of those who aid or abet were "in connection with" the purchase or sale of the securities,<sup>50</sup> its holding made for an interesting counterpart to the Second Circuit's decision in

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40. *Id.* at 725-27.

41. *Id.* at 731.

42. *Id.*

43. Lewis D. Lowenfels & Alan R. Bromberg, *Rule 10b-5's "In Connection With": A Nexus For Securities Fraud*, 57 BUS. LAW. 1, 10 (2001).

44. Fletcher, *supra* note 38, at 926.

45. 421 U.S. at 740.

46. *Id.* at 733 n.5 (emphasis omitted).

47. See, e.g., *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984); *Ketchum v. Green*, 557 F.2d 1022, 1026 (3d Cir. 1977) (discussing the trend toward broad interpretation); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977).

48. 511 U.S. 164 (1994).

49. *Id.* at 191.

50. See *id.* (reasoning that the text of section 10(b) does not prohibit aiding and abetting).

*Texas Gulf*. As noted above, the court in *Texas Gulf* held that perpetrators of fraud need not participate in the purchase or sale of the pertinent securities in order for the fraud to be “in connection with” such purchase or sale.<sup>51</sup> After *Central Bank* defendants could have been tempted to argue that because § 10b does not apply to aiders and abettors, the statute is similarly inapplicable to all non-participants in the securities transaction relating to the fraud. The Court in *Central Bank* went on, however, to provide that

[t]he absence of [section] 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under 10b-5 are met.<sup>52</sup>

Thus, in spite of foreclosing Rule 10b-5’s application to aiders and abettors, the Court left stockbrokers, accountants, and other third-party nontraders open to liability.<sup>53</sup>

In *United States v. O’Hagan*,<sup>54</sup> the Supreme Court analyzed the “in connection with” requirement in a different context: misappropriation of nonpublic, material information.<sup>55</sup> Defendant in *O’Hagan* gained material and nonpublic information by virtue of the fact that he was a partner in a law firm that represented a company on the verge of announcing a tender offer for the common stock of another company. Defendant did no work on the representation of the company, but traded on the company’s confidential information for his own personal gain.<sup>56</sup> The questions before the Court were (1) whether O’Hagan’s breach of fiduciary duty was a “deceptive device,” and (2) whether such deception was “in connection with” his purchases and sales of securities.<sup>57</sup> The Court determined that the act of trading on the confidential information was a deceptive device upon the company because a fiduciary relationship existed, which gave rise to an affirmative duty to abstain from trading on information gained as a result of the relationship.<sup>58</sup> The Court then held that the deception was “in connection with” defendant’s

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51. 401 F.2d at 860-62.

52. 511 U.S. at 191.

53. *See id.*

54. 521 U.S. 642 (1997).

55. *Id.* at 647.

56. *Id.* at 647-49.

57. *Id.* at 651.

58. *Id.* at 652.

purchase and sale of the securities because his fraud was consummated, not when he acquired the information, but when he used the information to make the purchases and sales of securities.<sup>59</sup> In this manner, “[t]he securities transaction and the breach of duty . . . coincide[d],” and the nexus requirement was thus satisfied.<sup>60</sup>

The nexus requirement was similarly satisfied in *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*,<sup>61</sup> where the Court held that a company’s secret intent not to permit the purchaser of a buy-out option to exercise the option amounted to a misrepresentation “in connection with” the sale of that stock option.<sup>62</sup> The Court concluded that the secret intent not to honor the option was a fraud for purposes of section 10(b) because a buyer normally presumes good faith.<sup>63</sup> This holding was similar to *O’Hagan* because in both cases, a defendant’s failure to disclose constituted the kind of fraud prohibited by the statute and the rule. The result of these cases is that the scope of the rule was expanded as more types of fraud fell within its purview.

### III. COURT’S RATIONALE

In *SEC v. Zandford*,<sup>64</sup> the Supreme Court unanimously held that a broker’s acceptance of payment for securities that he never intends to deliver and the sale of securities with intent to misappropriate the proceeds are fraudulent acts that are “in connection with” the securities transaction.<sup>65</sup> Writing for the Court, Justice Stevens was careful to note that the question presented involved the sufficiency of the complaint, not the district court’s grant of summary judgment.<sup>66</sup> Accordingly, the Court’s decision assumed that the allegations contained in the complaint were true, and the Fourth Circuit’s decision would be affirmed only if no set of facts would entitle petitioner to relief.<sup>67</sup>

The Court began its analysis of the case by quoting the “in connection with” language of section 10(b) and Rule 10b-5.<sup>68</sup> Justice Stevens

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59. *Id.* at 656.

60. *Id.*

61. 532 U.S. 588 (2001).

62. *Id.* at 589-90.

63. *Id.* at 596.

64. 535 U.S. 813, 122 S. Ct. 1899 (2002).

65. 122 S. Ct. at 1903.

66. *Id.* at 1902-03.

67. *Id.*

68. *Id.* at 1903.

briefly summarized the congressional intent of the provisions, which was to “insure honest securities markets”<sup>69</sup> and “substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.”<sup>70</sup> In accordance with this intent, Justice Stevens noted that the Court has consistently construed section 10(b) flexibly rather than narrowly.<sup>71</sup>

Foreshadowing its holding, the Court acknowledged as reasonable the SEC’s consistently held position that a broker who accepts payment for securities that he never intends to deliver or who sells customer securities with the intent to misappropriate the proceeds violates section 10(b) and Rule 10b-5.<sup>72</sup> While conceding that section 10(b) is not to be construed so broadly as to “convert every common-law fraud that happens to involve securities into a violation of [section] 10(b),” Justice Stevens observed that a misrepresentation does not necessarily have to concern the value of a particular security in order to contravene the statute.<sup>73</sup>

The Court then addressed respondent’s argument that the broker’s sales of securities were lawful in and of themselves and that the subsequent misappropriation of the proceeds, while fraudulent, was not “in connection with” the sales.<sup>74</sup> The Court rejected this argument on the ground that the complaint alleged that

respondent engaged in a scheme to defraud the Woods beginning in 1988, shortly after they opened their account, and that scheme continued throughout the two-year period during which respondent made a series of transactions that enabled him to convert the proceeds of the sales of the Woods’ securities to his own use.<sup>75</sup>

Thus the complaint alleged that the fraud was perpetrated as the securities were being sold. That the fraud allegedly “coincided” with the securities sales, rather than taking place before or after a lawful transaction, was of utmost significance in the Court’s conclusion that the fraud was in connection with the securities sales.<sup>76</sup> The Court emphasized that each sale of securities was made by Zandford to further his fraudulent scheme.<sup>77</sup>

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69. *Id.* (quoting *O’Hagan*, 521 U.S. at 658).

70. *Id.* (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)).

71. *Id.* (citing *Affiliated Ute Citizens*, 406 U.S. at 151).

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* (internal quotation omitted).

76. *See id.* at 1903-04.

77. *Id.* at 1904.

Addressing the issue of whether the fraudulent scheme was “in connection with” the sales in question, the Court determined that *Zandford* was closely analogous to *Bankers Life*.<sup>78</sup> In *Bankers Life* investors authorized the sale of certain treasury bonds because they were deceptively told that they would receive the proceeds of the sale.<sup>79</sup> The Court in *Zandford* observed that this deception is exactly what happened to the Woods; the Woods were deceptively told that respondent would “conservatively invest” their assets and that they would receive the proceeds.<sup>80</sup> Significantly, the Court emphasized again that respondent’s scheme to defraud “coincided” with the sale of securities.<sup>81</sup>

The Court then discussed the court of appeals conclusion that *Zandford* was distinguished from *Bankers Life* because *Zandford* did not make an affirmative misrepresentation about his intent to misappropriate the Woods’ assets.<sup>82</sup> The Court rejected this analysis, stating,

Under these circumstances, respondent’s fraud represents an even greater threat to investor confidence in the securities industry than the misrepresentation in *Bankers Life*. Not only does such a fraud prevent investors from trusting that their brokers are executing transactions for their benefit, but it undermines the value of a discretionary account like that held by the Woods.<sup>83</sup>

Moreover, the Court provided that in the context of a fiduciary relationship, such as that between a broker and his client, there can be no distinction between an omission and a misrepresentation.<sup>84</sup>

Citing *Wharf (Holdings) Ltd.*, the Court noted that it had previously based a determination that a seller had violated section 10(b) on the seller’s secret intent.<sup>85</sup> Because the complaint in this case alleged that respondent sold the Woods’ securities with the secret intent to keep the proceeds, the complaint was sufficient in alleging that the fraud occurred “in connection with” the purchase or sale of a security.<sup>86</sup>

Finally, the Court analogized *Zandford* to *O’Hagan*, stating that in both cases the securities transactions coincided with the fraudulent act.<sup>87</sup> The Court explained that because the breaches of respondent’s

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78. *Id.*

79. 404 U.S. at 9.

80. 122 S. Ct. at 1904.

81. *Id.*

82. *Id.* at 1905.

83. *Id.*

84. *Id.* (citing *Chiarella v. United States*, 445 U.S. 222, 230 (1980)).

85. *Id.*

86. *Id.*

87. *Id.*

fiduciary duty were alleged to coincide with the securities transactions, just as those in *Bankers Life, Wharf (Holdings) Ltd.*, and *O'Hagan*, such breaches or fraudulent acts were sufficiently alleged to have been "in connection with" the securities transactions.<sup>88</sup> In a footnote though, the Court was careful to point out that its holding "does not transform every breach of fiduciary duty into a federal securities violation."<sup>89</sup> The Court elaborated on the point by using the example of a broker who embezzles cash from a client and engages in a fraudulent real estate transaction, stating that this would not fall under section 10(b) as there is no securities transaction involved.<sup>90</sup>

#### IV. IMPLICATIONS

In *Zandford* the Court effectively set forth a new test to determine whether the "in connection with" requirement is satisfied: The requirement is satisfied whenever a fraudulent scheme coincides with the purchase or sale of a security.<sup>91</sup> Under this test the subject of an explicit misrepresentation or a misleading omission is irrelevant, as long as the misrepresentation or omission coincides with a securities transaction.<sup>92</sup> In *Bankers Life* the Court established that the fraud did not have to relate to the value of a particular security.<sup>93</sup> In *Zandford* the Court went a step further and provided that the fraud did not have to relate to a particular security at all.<sup>94</sup> Charles Zandford's fraud pertained only to whose benefit the Woods' assets were being invested; it did not relate to any one security in particular.<sup>95</sup> In this manner the Court's holding will undoubtedly broaden the scope of section 10(b). Any fraud that coincides with a securities transaction may now be held to fall within the purview of the statute even if such fraud fails to relate to particular securities.<sup>96</sup>

Another significant aspect of *Zandford* lies in the Court's adoption of the "shingle theory."<sup>97</sup> The shingle theory is based on the idea that a

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88. *Id.*

89. *Id.* at 1906 n.4.

90. *Id.*

91. See *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1130 (9th Cir. 2002).

92. Compare *Zandford*, 238 F.3d at 566 (noting, "Zandford's statements or omissions were not about a particular security"), with *Zandford*, 122 S. Ct. at 1904 (holding that Zandford's misleading omissions were in connection with the securities transactions notwithstanding the fact that the omissions did not relate to a particular security).

93. See *Sargent*, 492 F.2d at 763.

94. See *Zandford*, 122 S. Ct. at 1904.

95. See *id.* at 1901-02.

96. See *id.* at 1905-06.

97. See generally, *Leading Cases*, 116 HARV. L. REV. 200, 422 (2002).

stockbroker undertakes a broad obligation of good faith by hanging out his “shingle” to practice his trade, and it provides that fraudulent misrepresentations will be imputed to stockbrokers who silently fleece their clients.<sup>98</sup> The Court in *Zandford* adopted this theory by stating that “each time [Zandford] exercised his power of disposition for his own benefit, that conduct, without more, was a fraud.”<sup>99</sup> Thus, under *Zandford*, a stockbroker need not make any affirmative misrepresentation to violate section 10(b); he only has to disregard his customer’s best interests—breach his fiduciary duty. The effect of this adoption is similarly expansive in that another form of fraud now constitutes one of the deceptive devices prohibited by the statute.

For example, under *Zandford*, “churning” will likely be deemed a violation of section 10(b) and Rule 10b-5.<sup>100</sup> Churning occurs when a stockbroker engages in excessive trading in an attempt to generate commission income for himself without regard to the investment objectives of the customer.<sup>101</sup> Because this over-trading is done in the broker’s rather than the customer’s best interest, churning violates a broker’s fiduciary duty, which under *Zandford*’s adoption of the shingle theory, amounts to the kind of fraud prohibited by section 10(b) and Rule 10b-5. Lower courts have consistently held that churning violates section 10(b) and Rule 10b-5,<sup>102</sup> and the Court’s holding in *Zandford* implicitly affirms such holdings.

The question remains whether this holding suggests that a broker’s misrepresentations about his qualifications as a broker will create a cause of action under Rule 10b-5.<sup>103</sup> After *Zandford*, Rule 10b-5 liability could be triggered when a broker misstates his qualifications and an investor chooses to invest his money with the broker based on those misstatements and loses the money as a result. Because the fraudulent scheme could be said to have coincided with particular securities transactions, and the fraud no longer needs to relate to a security, such fraud could be deemed “in connection with” the transactions.

Ultimately, the “coincide” test of *Zandford* is not unlike the “touching” test of *Bankers Life*. Both tests allow for overly broad readings of the “in

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98. *Id.* at 428.

99. 122 S. Ct. at 1904 (internal quotation omitted).

100. *Leading Cases*, *supra* note 97, at 428-29.

101. *See, e.g.*, *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1367 (7th Cir. 1983).

102. *See, e.g.*, *Angelastro v. Prudential-Bache Sec., Inc.* 764 F.2d 939, 943 (3d Cir. 1985); *Costello*, 711 F.2d at 1368; *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416-17 (11th Cir. 1983).

103. *See Leading Cases*, *supra* note 97, at 430-41.

connection with" requirement, and neither shed much light on the actual meaning of the requirement. In the end, the "in connection with" requirement was best explained thirty-one years ago in the following statement: "For [the 'in connection with' requirement to be satisfied], the securities transaction should be an essential link in the mismanagement scheme and should have been undertaken for the purpose of making possible the practices alleged to be deceptive ...."<sup>104</sup>

J. PAGE SCULLY

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104. *The Supreme Court, 1971 Term—Leading Cases*, 86 HARV. L. REV. 52, 264 (1972).