LEGISLATION

STATUTORY PROTECTION OF THE STOCKBROKER'S CUSTOMER FROM UNAUTHORIZED SALES AND PLEDGES OF HIS SECURITIES—A broker, if he has possession or control of his customer's bonds or shares of stock, properly indorsed to transfer title, has the power so to dispose of these securities as to give the transferee the right to withhold them from the customer, either permanently, should the transfer be a sale, or until payment of the indebtedness secured by them, should it be a pledge.[1] Lack of authority to transfer the stock does not defeat the claim of a purchaser or pledgee for value without notice of any defect in the broker's right of disposal.[2]

It appears to be impracticable for the customer to protect himself against the exercise by an unscrupulous broker of this power over his stocks and bonds. The system of buying and selling securities through brokers dealing with one another as principals, on the behalf of undisclosed customers, involves even in a cash transaction the passage of the stock, indorsed to transfer title, through the hands of both the vendor's and the vendee's broker on its way to the purchaser. And in margin transactions the broker, for his own protection, in order to render effective the lien which he has on all securities purchased by him on margin for the customer or deposited with him as margin,[3] will demand that he be given an assignment in blank of the securities held by him.[4] Without this, he would be unable to borrow, upon a re-pledge of his customer's securities as collateral, the money necessary to carry the transaction, or to sell the securities in satisfaction of his lien should the customer fail to repay his advances.[5]

The customer's chief common law remedy for a misappropriation of his securities is an action for conversion against the broker. Every unauthorized sale or pledge of another's property is a conversion at common law.[6] It is a conversion for a broker having a lien on a particular security to hypothecate it for

[1] McNeil v. Tenth Nat. Bank, 46 N. Y. 325 (1871); Shattuck v. American Cement Co., 205 Pa. 197, 54 Atl. 785 (1903). This rule is incorporated in the Uniform Stock Transfer Act, § 7, 6 UNIFORM LAWS, ANNOTATED (1922) 12.

[2] Furber v. Dane, 203 Mass. 108, 89 N. E. 277 (1909); Matter of Mills, 125 App. Div. 730, 110 N. Y. Supp. 314, *aff'd* 193 N. Y. 626, 86 N. E. 1126 (1908).

[3] The customer becomes owner of the stock from the moment of its purchase by the broker, Sproul v. Sloan, 241 Pa. 284, 88 Atl. 501 (1913), even though the latter has advanced all the purchase money, Lamprecht v. State, 84 Ohio St. 32, 95 N. E. 656 (1911). But the broker has a lien on the stock purchased and becomes a pledgee thereof to the extent of the advances made by him in executing the customer's order, Sterling's Estate, 254 Pa. 155, 98 Atl. 771 (1916).

[4] The broker has a right to take title in his own name to stock purchased on margin for a customer, Hortan v. Morgan, 19 N. Y. 170 (1859); Shiel v. Stoneham, 77 Misc. 125, 135 N. Y. Supp. 1024 (1911).

[5] As an implied term of the contract between customer and broker, the latter has a right to re-pledge, up to the amount of his advances, all securities of the former on which he has a lien, whether purchased by the broker on margin, or deposited by the customer as collateral, Douglas v. Carpenter, 17 App. Div. 329, 45 N. Y. Supp. 219 (1897); Turner v. Schwartz, 140 Md. 465, 117 Atl. 904 (1922); Skiff v. Stoddard, 63 Conn. 198, 26 Atl. 874 (1893). *Contra:* Westinghouse v. German Nat. Bank, 188 Pa. 630, 41 Atl. 734 (1898) (as to securities *deposited* by the customer *to secure* his margins). The broker's right, in the absence of an agreement to the contrary, to re-pledge securities *bought on margin* for a customer is, however, expressly recognized by statute in Pennsylvania, Act of June 10, 1881, P. L. 107, § 1, PA. STAT. (West, 1920) § 8030.

But the broker has no lien on and no implied authority to pledge stock for which the customer has fully paid, *In re* J. C. Wilson & Co., 252 Fed. 631 (D. C. S. D. N. Y. 1917), or left with him for sale or safekeeping only, Austin v. Hayden, 171 Mich. 38, 137 N. W. 317 (1912).

[6] Kittredge v. Grannis, 244 N. Y. 168, 155 N. E. 88 (1926).

a larger sum than he has advanced thereon to the owner,[7] or to hypothecate a security deposited as collateral before he has made any advances [8] or after his advances have been repaid.[9] If the broker has authority to sell for a specific purpose, it is a conversion for him to sell for another,[10] or to pledge instead of selling.[11] "The result of the authorities is that if the agent parts with the property, in a way or for a purpose not authorized, he is liable for a conversion. But if he parts with it in accordance with his authority, though at a less price, or if he misapplies the avails, or takes inadequate for sufficient security, he is not liable for the conversion of the poperty." [12]

Yet in actual practice the broker's liability in damages is not a very effectual deterrent to unauthorized appropriations of his cusomers' securities because of the ease with which a broker may conceal an unauthorized sale or pledge. A broker is under no obligation to return to the owner the specific securities deposited with him,[13] but fulfils his legal duties towards his customer by always having available for delivery, on tender and demand by the customer, securities of like kind with those pledged in sufficient amount (including those properly re-hypothecated) to satisfy all customers.[14] A consequence of this rule is that if the broker is able to deliver upon demand, an intervening technical conversion will ordinarily pass undiscovered, thus enabling the broker to successfully conceal his misappropriations by using one customer's bonds to pay off another as long as he continues apparently solvent.[15] Statutory abrogation of the rule in its entirety, however, would hamper the legitimate conduct of credit transactions because free interchangeability of securities is essential to the pledges *en bloc* of stocks, through which brokers procure the cash necessary to carry their customers' margin accounts.[16]

There remains, as a preventative for unauthorized transfers by a broker, the sanction of criminal penalties. But the technicalities of common law larceny have excluded from the scope of that offense most misappropriations of securities by brokers. Under the established doctrine it is impossible for a stockbroker to be convicted of larceny unless there be proof that he fraudulently induced the owner to deliver to him the property converted.[17] For a broker, in his capacity as agent, has possession, not custody, of the securities he holds for another's interest,[18] and accordingly he cannot be guilty of a trespass except at the moment he obtains possession of them, nor guilty of a trespass against the owner unless he secures possession from him by force or fraud.[19] Furthermore larceny requires an intent, existing at the time of the trespass, to permanently deprive the owner of his property. There has been considerable doubt whether the existence of this intent should be inferred from an unauthorized pledge.[20] The rule would seem

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[7] Wood v. Fisk, 215 N. Y. 233, 109 N. E. 177 (1915).
[8] *In re* Tracy, 191 Fed. 810 (C. C. A. 2d, 1911).
[9] Van Voorhis v. Rea, 153 Pa. 19, 25 Atl. 800 (1893).
[10] Kittredge v. Grannis, *supra* note 6.
[11] See Parsons v. Martin, 11 Gray 111 (Mass. 1858).
[12] Laverty v. Sneathen, 68 N. Y. 522, 527 (1877).
[13] Richardson v. Shaw, 209 U. S. 365, 28 Sup. Ct. 512 (1908).
[14] Turner v. Schwartz, *supra* note 5; Commonwealth v. Nixon, 94 Pa. Super. 333 (1928).
[15] People v. Atwater, 229 N. Y. 303, 128 N. E. 196 (1920). For a discussion of the difficulties involved in determining the priorities of various customers in bankruptcy, and the consequent trouble which they incur in recovering their property or an indemnity therefor, see Oppenheimer, *Rights and Obligations of Customers in Stockbrokerage Bankruptcies* (1924) 37 HARV. L. REV. 860.
[16] CAMPBELL, STOCKBROKERS (2d ed. 1922) 46.
[17] People v. Meadows, 199 N. Y. 1, 92 N. E. 128 (1910); CLARK, CRIMINAL LAW (3d ed. 1915) 320 *et seq.*
[18] Commonwealth v. Althouse, 207 Mass. 32, 93 N. E. 202 (1910); 2 BISHOP, CRIMINAL LAW (9th ed. 1923) 628, 633.
[19] Commonwealth v. Althouse, *supra* note 18; 2 BISHOP, *op. cit. supra* note 18, at 615, 622.
[20] Regina v. Phaetheon, 9 Car. & P. 552 (Eng. 1840).

to be that a pledge does not necessarily show an intent to permanently deprive the owner of his property, since the pledgor retains the right to recover the pledge,[21] but that the jury may be justified in inferring from the attendant circumstances that the accused did not intend to exercise this right and restore the property.[22] In connection with a similar question the New York Court of Appeals has said:

> "A re-pledge, unlike a sale, does not involve an absolute repudiation of the title of the primary pledgor. . . . The conversion is partial and technical rather than absolute and malicious.[23]

Yet the pledgee's limited property will become absolute if the pledgor does not redeem.[24]

Embezzlement statutes have dispensed with the necessity of a trespass,[25] but they raise new difficulties by reason of their being construed to require a fiduciary relationship between the accused and the owner of the property embezzled, whether referring to "any persons" or to specific classes of agents and fiduciaries.[26] The broker who has a lien on securities in his possession is an agent in respect to his obligation to deal with the securities as directed by his customer, a creditor in respect to the customer's indebtedness to him for his advances, and a pledgee in respect to his right to retain the securities as collateral for that indebtedness.[27] This tri-partite relationship led to a decision that where the statute required the property to have been received by the accused "by virtue of his employment as agent", a broker could not be convicted of embezzling property delivered to him as collateral security for a customer's margins because such property was not delivered by virtue of his employment, but by virtue of his position as creditor.[28] A broker obligated to redeliver the securities pledged with him as collateral may be convicted, however, of the crime of embezzlement by a bailee.[29] On the other hand it has been held that a broker holding securities for sale or exchange cannot be convicted of embezzling them as bailee, although he may be convicted of embezzling their proceeds if he sells them with intent to defraud. This decision was placed in one case on the ground that as the parties did not contemplate the return of the securities to the customer, or the return of securities of like kind, there could be no bailment.[30] In another it was placed on the ground that the broker, being authorized to sell, could not convert the property by selling it for his own benefit.[31] Both decisions raise the contested question whether a general authority to sell is in reality a specific authority to sell for the principal's benefit. If it is, then the sale is a conversion and the relationship is that of bailment since the securities would then have been delivered as property of the customer deposited for a special purpose only. Accordingly in other cases

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[21] Regina v. Wright, 9 Car. & P. 554 n. (Eng. 1828).

[22] Truslow v. State, 95 Tenn. 189, 31 S. W. 987 (1895). There should be evidence of both the ability and the expectation to redeem, Regina v. Medland, 5 Cox Cr. Cas. 292 (Eng. 1851); Regina v. Tribilcock, 7 Cox Cr. Cas. 408 (Eng. 1858).

[23] Wood v. Fisk, *supra* note 7, at 239, 241, 109 N. E. at 178, 179.

[24] 2 BISHOP, *op. cit. supra* note 18, at 641.

[25] People v. Meadows, *supra* note 17; Commonwealth v. Nixon, *supra* note 14, where the broker was convicted of embezzling a customer's securities though the stock certificate had never come into the possession of either.

[26] CLARK, *op. cit. supra* note 17, at 357; 2 BISHOP, *op. cit. supra* note 18, at 294.

[27] Austin v. Hayden, *supra* note 5; Markham v. Jaudon, 41 N. Y. 235 (1869).

[28] Buddeke v. State, 12 Ohio C. C. (N. S.) 454 (1910), *aff'd* 83 Ohio St. 451, 94 N. E. 1116 (1910).

[29] People v. Tambara, 192 Cal. 236, 219 Pac. 745 (1923). In State v. Peck, 299 Mo. 454, 253 S. W. 1019 (1923), the court doubted whether a broker holding securities as pledgee could be convicted of embezzling them as bailee.

[30] People v. Wildeman, 325 Ill. 99, 156 N. E. 257 (1927).

[31] State v. Peck, *supra* note 29.

authority to sell has not prevented the broker from being convicted of embezzling the securities sold.[32]

Assuming the necessary relationship of trust to be shown any act amounting to a conversion suffices to bring the broker within the statute.[33] Many embezzlement laws in terms define the crime as being the "fraudulent conversion" of property.[34] Not only is an unauthorized hypothecation embezzlement,[35] but a hypothecation in an authorized manner, as by pledging a bond apart from the note secured by it, may also be embezzlement.[36] A taking from the owner's possession is unnecessary.[37]

Yet in no event is the broker guilty of embezzlement, however unauthorized his act, unless he has an intent to defraud the owner of his property at the moment of conversion.[38] This element of intent was early read into embezzlement statutes not expressly requiring it by analogy to the wrongful intent in larceny,[39] and has carried with it the same haziness respecting the intent to be inferred from an unauthorized hypothecation.[40]

In some jurisdictions an attempt has been made to prescribe a more definite or a more stringent standard for the stockbroker than that afforded by the ordinary criminal law. This attempt is evidenced by statutes providing that an agent or broker who appropriates money or property entrusted to him in a manner contrary to his *written* instructions is guilty of a distinct crime.[41] Where the violated instructions are written there is less danger that the broker has misunderstood the real nature of his authority, and consequently more ground for rigorous punishment. These statutes also in general define the criminal act as being any disposition of the property for a purpose, or in a way contrary to the customer's written directions,[42] terms susceptible of broader application than has been given to common law conversion. They require, however, that the misappropriation be "in violation of good faith",[43] or made "purposely and intentionally",[44] or be

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[32] People v. Stafford, 81 Cal. App. 159, 253 Pac. 183 (1927). And see Mearns v. Chatard, 47 App. D. C. 257 (1918); Kittredge v. Grannis, *supra* note 6; Landrum v. State, 73 Tex. Crim. Rep. 580, 166 S. W. 726 (1914).

[33] Brown v. State, 3 Ohio App. 52 (1914); State v. Alexander, 140 S. C. 325, 138 S. E. 835 (1927); 2 BISHOP, *op. cit. supra* note 18, at 311.

[34] ILL. REV. STAT. (Cahill, 1929) c. 38, §§ 39, 188; PA. STAT. (West, 1920) §§ 7816, 7830.

[35] Commonwealth v. Butterick, 100 Mass. 1 (1868); Hayes v. State, 14 Ohio C. C. (N. S.) 497 (1910), *aff'd* 83 Ohio St. 490, 94 N. E. 1107 (1910).

[36] People v. Tambara, *supra* note 29.

[37] If property in the security has been transferred to the broker he cannot be convicted of either larceny or embezzlement even though he fraudulently procured the transfer, see Landrum v. State, *supra* note 32, at 581, 166 S. W. at 727; CLARK, *op. cit. supra* note 17, at 332. A misappropriation of the security is then only a breach of contract, not a conversion, Sackville v. Winer, 76 Colo. 519, 233 Pac. 1527 (1925).

Since in Massachusetts, contrary to the general rule, a broker is considered owner of securities purchased by him on margin for a customer, Wood v. Hayes, 15 Gray 375 (Mass. 1860); Chase v. Boston, 180 Mass. 458, 62 N. E. 1058 (1902), the broker cannot be guilty in that state of stealing securities purchased on a customer's order if still unpaid for by the latter.

[38] State v. Parker, 112 Conn. 39, 151 Atl. 325 (1930); Brown v. State, *supra* note 33.

[39] State v. Parker, *supra* note 38; State v. Eastman, 60 Kan. 557, 57 Pac. 109 (1899).

[40] See State v. Larson, 123 Wash. 21, 211 Pac. 885 (1923), where it was held that an intent to defraud was to be inferred from the defendant's act in putting the property beyond his control. Once it is established that the property was sold or pledged with fraudulent intent an expectation of ultimately making restitution is no defense, People v. Schrager, 315 Ill. 169, 146 N. E. 151 (1924).

[41] "This is not a statute to punish embezzlement, but to protect persons who place in charge of another funds for control and investment, accompanied by specific instructions." People v. Karste, 132 Mich. 455, 459, 93 N. W. 1081, 1082 (1903).

[42] MD. ANN. CODE (Bagby, 1924) Art. 27, §§ 165, 166; 3 MICH. COMP. LAWS (1929) § 16913.

[43] MD. ANN. CODE (Bagby, 1924) Art. 27, §§ 165, 166.

[44] 3 MICH. COMP. LAWS (1929) § 16913.

performed by embezzling or fraudulently converting the property,[45] thereby perpetuating the requisite of a fraudulent intent. Similar efforts toward the same end may be seen in statutes expressly forbidding any person holding as security for a debt stocks, or other property the title to which passes by delivery or endorsement, to repledge or re-hypothecate such security during the continuance of the contract of pledge or hypothecation without the consent of the owner.[46] It has been held that such a statute does not apply to stock held by a broker as security for his customer's margins because authority to repledge such stock is presumed from the custom of brokers.[47] The principles of the foregoing statutory types sometimes appear in various composite forms as in a Maryland statute providing that any broker or agent entrusted with money or a security for the payment of money, with written instructions how to apply such property, is guilty of a misdemeanor in converting it to his own use contrary to the specified purpose; but that a broker or agent entrusted with a chattel, valuable security, or power of attorney to transfer stock, without authority to sell or pledge, is guilty of a separate misdemeanor in disposing of such property contrary to his instructions.[48] The offense created by the foregoing statutes is usually of the grade of a misdemeanor. Judging from the decided cases none of these enactments appears to have accomplished a great deal in curbing misappropriations by stockbrokers. But they do show that many legislative bodies have realized the risk borne by the customer through the broker's power over his securities.[49]

In 1913, this realization evolved into a new type of statute, referred to in New York, the state of its origin, as the "Stilwell Act",[50] and now adopted in three other states.[51] This statute first departed from the model of earlier enactments by carefully defining two separate offences capable of being committed only by stockbrokers: (1) selling or pledging a customer's securities in the broker's possession, the broker having no lien thereon, without the customer's consent; (2) selling or pledging a customer's securities in the broker's possession, the broker having a lien thereon, without the customer's consent, and in the case of a pledge

[45] 2 MASS. GEN. LAWS (1921) c. 256, § 56.

[46] MD. ANN. CODE (Bagby, 1924) Art. 27, § 211; 2 MASS. GEN. LAWS (1921) c. 256, § 85; PA. STAT. (West, 1920) § 8030.

[47] Furber v. Dane, *supra* note 2.

[48] MD. ANN. CODE (Bagby, 1924) Art. 27, §§ 165, 166. A similar provision was formerly in force in England, by The Larceny Act, 1861, 24 & 25 VICT. c. 96, § 75, repealed by 6 & 7 GEO. V c. 50, § 48 (1916).

[49] For a discussion of the extent of this power and the need of legislative correction see Smith, *Margin Stocks* (1922) 35 HARV. L. REV. 485.

[50] "A person engaged in the business of purchasing and selling as a broker stocks, bonds or other evidences of debt of corporations, companies or associations, who

"(1) Having in his possession, for safe keeping or otherwise, stocks, bonds or other evidences of debt of a corporation, company or association belonging to a customer, without having any lien thereon or any special property therein, pledges or disposes thereof without such customer's consent; or

"(2) Having in his possession stocks, bonds or other evidences of debt of a corporation, company or association belonging to a customer on which he has a lien for indebtedness due to him by the customer, pledges the same for more than the amount due to him thereon, or otherwise disposes thereof for his own benefit, without the customer's consent, and without having in his possession or subject to his control, stocks, bonds or other evidences of debt of the kind and amount to which the customer is then entitled, for delivery to him upon his demand therefor and tender of the amount due thereon, and thereby causes the customer to lose, in whole or in part, such stocks, bonds or other evidences of debt, or the value thereof,

"Is guilty of a felony, punishable by a fine of not more than five thousand dollars or by imprisonment for not more than two years, or by both.

"Every member of a firm of brokers, who either does, or consents or assents to the doing of any act which by the provisions of this . . . section is made a felony, shall be guilty thereof." N. Y. Laws 1913, c. 500, N. Y. CONS. LAWS (Cahill, 1930) c. 41, PENAL LAW § 956.

[51] Ky. Laws 1928, c. 14 (section relating to non-lienholder brokers alone enacted); 2 MICH. COMP. LAWS (1929) § 9800; OHIO ANN. CODE (Throckmorton, 1930) § 13108-2.

for more than the customer's indebtedness to the broker. This novel distinction between unauthorized acts by brokers without liens and unauthorized acts by brokers with liens was further emphasized by two important limitations, expressly imposed by the legislature on the scope of the latter offence, and therefore leading to the inference that the former was intended not to be thus restricted.

The first of these restrictive clauses, in providing that no offense is committed if the broker, when disposing of his customer's securities, keeps on hand sufficient securities of the kind and amount to which the customer is entitled, simply expresses the common law rule that the broker is not obligated to deliver to the customer the specific securities entrusted to him.[52] Or, as more precisely put in the Ohio statute, the broker satisfies both his common law and statutory obligations by "having in his possession or subject to his control" securities "of the same kind and amount available for free delivery and sufficient to satisfy all customers entitled thereto upon demand thereof and tender of the amount due thereon." [53] The basis of this rule is that the stock certificate or bond is not property itself, but only evidence of an undivided interest in the assets or obligation of the corporation, which interest remains the same whether evidenced by one certificate or another.[54] The omission of the clause expressing this rule from the first section of the "Stilwell Act", if it be correctly regarded as abrogating the rule, will oblige a broker holding securities for safekeeping or sale without a lien thereon to keep these certificates separate from his general stock of like securities in order to avoid improperly parting with their possession. While apparently the act imposes a useless impediment in demanding that the broker refrain from substituting one share of stock for its equivalent share, yet this requirement has the practical advantage of making it more difficult for a broker to conceal his misappropriations by juggling securities from one customer's account to another's. And legitimate transactions are not hampered inasmuch as the act expressly declares the common law to govern those transactions where the broker has a right to use his customer's securities for securing his own loans.

Even more striking is the other limitation in the clause relating to hypothecations by lienholder brokers expressed by the words, "and thereby causes the customer to lose, in whole or in part, such stocks, bonds or other evidences of debt, or the value thereof." Although no decision construing this clause has apparently been rendered, it literally imports that if a broker pledges his customer's securities for a greater amount than the latter's indebtedness, or wilfully converts them for his own purposes, he is nevertheless not guilty of a violation of the Act should the customer, who has borne the risk of the broker's speculation, ultimately recover his stock without loss. But if through misfortune the broker fails and a fall in the market prevents the owner's redeeming his shares with the money due the broker thereon, then the broker is a felon.[55] This is a novel experiment in criminal jurisprudence to make injury instead of intent the decisive element of a crime.[56] It may possibly be an attempt to mitigate the severe punishments, never passing below the grade of felony and reaching maximum penalties of from two to ten years' imprisonment, prescribed by these statutes, but, if so, it goes to the opposite extreme of exonerating altogether even a wilful wrongdoer.

The first doubt definitely resolved by the courts in interpreting the "Stilwell Act" arose from the use of the words "having possession" in the text of the

[52] Turner v. Schwartz, *supra* note 5; Commonwealth v. Nixon, *supra* note 14.

[53] OHIO ANN. CODE (Throckmorton, 1930) § 13108-2.

[54] JONES, COLLATERAL SECURITIES (3d ed. 1912) §§ 508-511.

[55] For an example see People v. Atwater, *supra* note 15, a case where the defendant's failure was due to thefts by his partners.

[56] CAMPBELL, *op cit. supra* note 16, at 52.

statute. In *People v. Atwater*[57] a broker had purchased Liberty Bonds for a customer through a correspondent broker giving the latter a promissory note for the purchase price and leaving the bonds with him as security for the note. The customer thereafter paid the broker in full for the bonds. Upon maturity of the note the broker, instead of taking up the bonds, renewed the note, and for this act he was convicted of unlawful hypothecation of a customer's securities. The Appellate Division reversed this conviction on the ground that the words "having possession" must be taken in their literal meaning and that a broker could not be convicted, therefore, under the statute unless he had actual physical possession or a present right to possession of the securities at the moment he hypothecated them. This decision was in turn reversed by the Court of Appeals and the broker's conviction reinstated on the theory that since at the time of renewing his loan he might have obtained, through a tender of the amount due on the note, the right to possession of the securities he had at that moment "constructive possession" of them. After considering the purpose of the statute the court concluded that the legislature intended to penalize all unauthorized pledges by brokers regardless of the precise form of the transaction, and that consequently the judges would be justified in giving to the word "possession" the broadest of its many meanings.[58]

The New York courts have also liberally construed the clause providing that any member of a brokerage firm "who either does or consents or assents to the doing of any act" forbidden by the statute is guilty of the felony therein created. Yet it is not enough for conviction that the assent be given after the act has been performed; there must be at least passive acquiescence while the act is being done by one's associate.[59] On the other hand knowledge that one's partner or employee is engaged in a wrongful act is unnecessary where the accused has himself established or tolerated a practice in his office the "inevitable consequence" of which is to lead to unauthorized hypothecations, as, for instance, instructing his clerk that he may pledge any securities endorsed by a member of the firm as guarantor unless specific instructions are attached thereto.[60] It would seem from this that the "Stilwell Act" reaches negligent as well as intentional conversions by a broker if accompanied by the requisite criminal intent.

That enactment contains no express requirement of a criminal intent. In construing it the implication of an intent to defraud, made in the case of embezzlement statutes, has been rejected in favor of an interpretation which requires an evil mind on the part of the broker, but which holds that this evil mind is present when a broker knowingly pledges or sells a customer's securities in an unauthorized manner.[61] The New York courts came to this decision because, in their estimation, the evil sought to be reached by the legislature was the risk of losing his property placed upon a customer by the broker's unauthorized act in giving another dominion over it. Therefore an interpretation was to be excluded which would make the broker's guilt depend upon an actual fraudulent intent. Such a construction would not have afforded the customer any greater security than that given by the embezzlement acts. However, to have dispensed with the necessity of a criminal mind altogether would have worked great hardship in making a broker guilty as a felon for an unauthorized pledge where by mistake he had pledged another's securities instead of his own. The severe penalties imposed by the act seemed some indication that the legislature considered the

[57] People v. Atwater, 191 App. Div. 345, 181 N. Y. Supp. 742 (1920), *s. c.* 229 N. Y. 303, 128 N. E. 196 (1920).

[58] That actual possession would have been necessary in embezzlement see Lamprecht v. State, *supra* note 3.

[59] People v. Lowe, 209 App. Div. 498, 205 N. Y. Supp. 77 (1924).

[60] People v. Sugarman, 216 App. Div. 209, 215 N. Y. Supp. 56 (1926), *aff'd* 243 N. Y. 638, 154 N. E. 637 (1926).

[61] People v. Atwater, *supra* note 57.

crime as involving conscious wrongdoing on the broker's part. Accordingly resort was had to the intermediate interpretation which requires knowledge by the broker that he is pledging another's security, thereby admitting the defence of mistake of fact, but which does not require an intent by him to deprive the customer of his property, thus excluding the defence of an expectation to restore the security pledged.[62]

This alteration in the requisite of intent, together with the definite extension of the criminal act to include all unauthorized hypothecations and sales, and the apparent abrogation of the rule permitting the non-lienholder broker to substitute one share of stock for another, makes the "Stilwell Act" the most adequate protection yet devised for the customer.[63] Furthermore this is accomplished without diminishing the rights of an innocent purchaser or pledgee for value.[64] But the statute in one important respect subjects an honest stockbroker to serious danger. It is in many jurisdictions an undecided question whether a broker converts securities held in pledge by re-hypothecating them, along with other securities, for an amount greater in the aggregate than the customer's indebtedness to the broker, but yet small enough for the *pro rata* share of the loan borne by the customer's securities to be within the authorized limit. Conflicting opinions have been rendered on this subject in New York.[65] In several other states such a pledge has been held illegal for the reason that the customer cannot recover his securities from this general pledge by tendering to the sub-pledgee the amount of his indebtedness to the broker.[66] Other decisions in reaching an opposite conclusion rely on custom and convenience, and consider that there is no conversion in such a case—as the owner is not deprived of his general property in the securities by the mere act of pledging—until there is a refusal to deliver upon tender and demand by the customer.[67] Because of the prevalence of the general pledge

[62] "Undoubtedly a criminal intent is necessary to constitute the crime of which the defendant was convicted; but the criminality of the intent consists of the intent to do the prohibited act with knowledge of all the facts constituting the crime—in this case that the bonds were the property of the customers, in the possession of the defendant for safe keeping or otherwise, and that the defendant had no lien thereon. . . . The intent to defraud which is an element of the crime of larceny, is not a constituent of the crime of hypothecation of customer's securities; it is an intent to knowingly do the wrongful act prohibited by the statute." People v. Atwater, *supra* note 57, at 350, 181 N. Y. Supp. at 746 (this point approved by the Court of Appeals).

[63] The "Stilwell Act" also affords the customer certain incidental protection through its effect on his civil rights. Formerly an unauthorized hypothecation was held not to be within the meaning of a clause in the Bankruptcy Act excepting liabilities for "wilful and malicious injuries to the property of another" from the operation of a discharge, Wood v. Fisk, *supra* note 7; but since the adoption of the former Act a liability for an unauthorized hypothecation has been held within this exception on the ground that the words "wilful and malicious" were to be treated as synonymous with "criminal", Heaphy v. Kerr, 190 App. Div. 810, 180 N. Y. Supp. 542 (1920), *aff'd* 232 N. Y. 526, 134 N. E. 557 (1921). So also the owners of stocks unlawfully pledged have priority in the proceeds of a pledge *en bloc* over the owners of stocks lawfully pledged therein, Blackenhorn-Hunter-Dulin Co. v. Thayer, 199 Cal. 90, 247 Pac. 1088 (1926), and in so far as the first section of the Act seems to make a pledge of the specific stocks delivered, even though like stocks are retained, illegal, the owner of such stock should receive a priority he formerly did not enjoy.

[64] That a sale or pledge is a crime on the part of the broker does not limit the transferee's right to retain the securities transfered as against an owner who has entrusted them to the broker, Fisher v. Clark, 3 F. (2d) 621 (D. C. S. D. N. Y. 1924) (transfer in violation of "Stilwell Act"); Draper v. Saxton, 118 Mass. 427 (1875) (transfer in violation of act forbidding re-pledge of collateral securities).

[65] *Cf.* Douglas v. Carpenter, *supra* note 5, and Strickland v. Magoun, 119 App. Div. 113, 104 N. Y. Supp. 429 (1907) (both holding a general pledge illegal), with Mayer v. Monzo, 151 App. Div. 866, 137 N. Y. Supp. 616 (1912) (declaring a general pledge not *ipso facto* a conversion).

[66] Turner v. Schwartz, *supra* note 5; Commonwealth v. Althouse, *supra* note 18; Sproul v. Sloan, *supra* note 3; Wahl v. Tracy, 139 Wis. 668, 121 N. W. 660 (1909).

[67] *In re* Swift, 105 Fed. 493 (D. C. Mass. 1900); Clark v. Baillie, 45 Can. S. C. 50 (1911).

in stockbrokerage practice [68] it is desirable that a statute imposing such severe penalties as the "Stilwell Act", and also dispensing with the necessity of a fraudulent intent should specifically inform the broker as to the legality of a pledge *en bloc* of his customer's securities.[69]

H. J. S.

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[68] While a broker can guard himself from prosecution by obtaining express authority from his customers to pledge their securities in general loans, it would seem that the notices commonly inserted on the memoranda furnished customers after a sale or purchase for their account are not in themselves sufficient to grant such authority without positive evidence of their being assented to by the customer, Turner v. Schwartz, *supra* note 5; Guthrie & Tenney, *Some Legal Problems Connected with Stock Market Transactions* (1930) 29 MICH. L. REV. 41.

[69] A clause legalizing the general pledge was inserted in the Michigan statute in 1925, Mich. Public Acts 1925, No. 204, § 2, but removed in 1929, Mich. Public Acts 1929, No. 220, § 32.